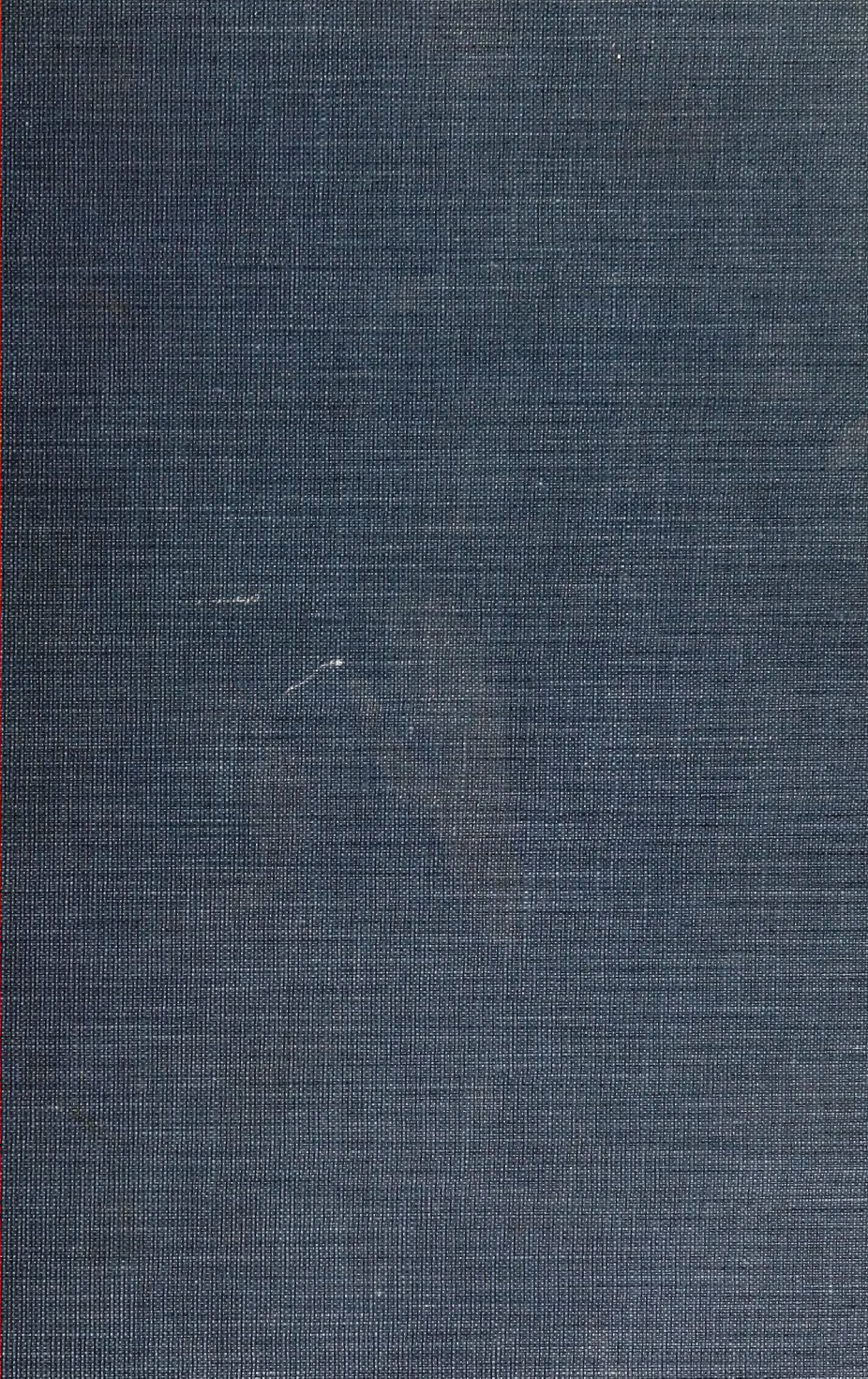
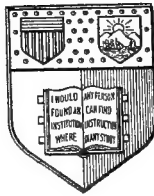






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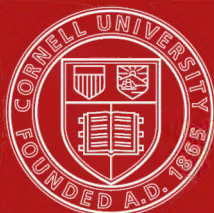
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Corporation Accounting

R. J. Bennett

BY

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To My Mother,

THE LATE ELLEN BARTLEY BENNETT,
THIS BOOK IS AFFECTIONATELY
DEDICATED

PREFACE

Corporation accounting does not differ in its essentials from the accounting of any other form of business organization. There are, however, certain transactions, accounts, and entries employed in it which are either peculiar to the corporation or so seldom encountered elsewhere that they may properly be termed distinctive. It is with these distinctive transactions and their accounting treatment that the present volume concerns itself, and not with the general problems of accountancy.

As companies are formed; as stocks of differing characteristics are subscribed for, issued on varying terms, forfeited, donated, resold or cancelled; as bonds of different classes are issued, sold, purchased or redeemed at maturity; as sinking funds and reserves are set up for the protection and redemption of these bonds; as dividends are declared or assessments are levied; as companies are reorganized, liquidated, or become insolvent, the accountant is confronted with difficult problems—problems which frequently, because of the magnitude of the amounts involved, or because of the legal consequences of error, call for a care and accuracy of treatment beyond the ordinary.

In all these matters the corporation accountant may well profit by the experience of those who have already grappled with and solved these problems, and it is the purpose of this volume to present such solutions and to set forth the established practice, wherever practice has been established. In this the author trusts he has been successful.

It must be said, however, that in the treatment of many corporate transactions, practice—and good practice—is not

uniform, though the final result is, of course, the same. Where this is true, the author has endeavored to give all the methods of treatment in good accounting use.

It may also be noted that most of the illustrative entries in the present work are, for the sake of clearness and simplicity, given in journal form even though many of them are cash entries that in practice would appear only in the cash book.

A considerable amount of space has been devoted to those details of corporate organization, practice, and procedure which more directly affect the work of the accountant. This information is so essential to the proper understanding and handling of the corporate accounts, that the author felt that it should not be omitted. Much of this has been taken from the works on corporate organization and management by Mr. Thomas Conyngton, to whom the author extends his sincere thanks.

The author also gratefully acknowledges the valuable assistance given by corporation officials, bankers, corporation accountants, public accountants and others, and especially by brother members of the Pennsylvania Institute of Certified Public Accountants.

R. J. BENNETT.

Philadelphia, Pa.

October 1. 1916.

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Corporation Accounting

Part I—Corporation Organization and Procedure

CHAPTER I

THE CORPORATE FORM

§ 1. Business Organization

There are three general forms under which business activities are conducted, viz.: the single proprietorship, the partnership, and the corporation. In a single proprietorship the business is conducted by an individual on his own account and for his own benefit. In a partnership the business is owned by two or more individuals and is conducted on a co-operative basis for mutual benefit, the partners participating in its management and in its profits. Under the corporate form, business is conducted for the benefit of the stockholders of the corporation by a board of directors elected by them. The corporation owns the business, and the stockholders own the corporation; so practically, though not technically, the stockholders own the business.

§ 2. The Corporation

A corporation is an association of individuals authorized by law to act as a whole under a corporate name and for some particular purpose or purposes. The word "company" is used synonymously with "corporation," with reference to business organizations.

The stock corporation is one whose authorized capital, or "capital stock," is divided into shares, each of which represents a definite interest in the corporation, and, ordinarily, entitles the owner of record to vote at corporate meetings and to participate both in corporate profits and in the assets of the corporation on its dissolution. The shares are called "stock," and their owners "stockholders."

In many states, corporations formed to carry on mining, manufacturing, or mercantile enterprises are called "business corporations," to distinguish them from banking and insurance companies, which are termed "moneyed or financial corporations," and from railroad, telegraph, telephone, ferry, and other like companies, which are called transportation or public utility corporations. While moneyed and public utility corporations are usually subject to much stricter regulations than "business corporations," they enjoy more extensive powers.

§ 3. Kinds of Corporations

Generally speaking, there are two kinds of corporations—those conducted for profit, and those *not* conducted for profit. Corporations for profit include railroad, banking, insurance, public utility, manufacturing, and trading companies. Corporations not for profit are conducted for the benefit of the community, as municipalities, hospitals, churches, and charitable, social, and literary societies. Under the Pennsylvania statutes these latter are known as "corporations of the first class," while those conducted for profit are classified as "corporations of the second class."

Under the New York statutes the classification is as follows:

1. Municipal corporations
2. Stock corporations
3. Non-stock corporations

Class 1 includes towns, counties, cities, villages, school districts, and other territorial divisions of the state which are established by law with powers of local government. Class 2 includes all corporations having a capital stock divided into shares, and which are conducted for profit. To Class 3 belong those which are conducted partly for the well-being of their members, as churches, cemeteries, co-operative organizations, boards of trade, and various benevolent institutions.

§ 4. Public Utility Corporations

Public utility corporations may be characterized as mixed or quasi-public, inasmuch as they operate for the convenience of the public as well as for profit to the management. They include the various transportation organizations, such as railroad, street-car, steamboat, and ferry companies; the telegraph and telephone companies; and the gas and electric light companies. Such corporations are usually relieved to some extent from competition, because this, it is thought, will result in better service to the public. Their activities are regulated by the terms of their franchises and by the laws and ordinances of the municipalities in which they operate. In many states they are subject to the supervision of public utility or public service commissions.

§ 5. Corporations Created by and Subject to State Laws

Corporations are a creation of the law, that is, the laws of each state and of the District of Columbia prescribe the manner in which corporations in such state or District shall be formed, and they may be formed only in accordance therewith—unless, as is sometimes done, they are authorized by a special legislative act—and have only such legal existence, rights and powers as are given them by such laws.

A corporation organized in one state (or in the District

of Columbia) may operate in other states, being known in its own state as a "domestic" corporation, and in other states as a "foreign" corporation. When a corporation carries on business in another state, it must comply with the laws of that state regulating "foreign" corporations. This is so because the rights and powers conferred by the laws of its own state exist for it in another state only as a matter of comity and subject to any regulations imposed on "foreign" corporations in that other state.

To state this more fully, "The corporations of one state may exercise any or all of their powers in another state, unless the latter state, by its statutes, decisions, or policy, forbids. This right of a corporation to act and contract in any state is due to the spirit of comity between the states. It is constitutional, however, for a state to refuse to allow that privilege, except as against corporations engaged in interstate commerce.

"A state may require a foreign corporation to pay a license fee before doing business within its borders. A statute of a state prohibiting a foreign corporation from doing business in the state, if such corporation is connected with a trust, is constitutional."*

As the conditions of incorporation and the powers and rights of corporations vary in the several states, the laws of the particular state must be consulted when the procedure for incorporation or the rights and powers of corporations in any particular state are to be known. It may also be noted that the laws with respect to the organization of public utility and moneyed corporations usually differ from those under which the ordinary business corporation is formed.

§ 6. Procedure for Incorporation

The state laws governing incorporation usually require

*Cook on Corporations, § 696.

that three or more persons—termed “incorporators”—must take part in forming a corporation, and that all or a part of these must be citizens of the United States. In some cases it is required that one or more must be citizens of the state in which the corporation is organized.

In all the states general laws have been passed prescribing the method of incorporation, together with special provisions in the case of financial and public utility corporations. In most states there are special laws for educational, benevolent, and other corporations of similar character, as well as for corporations the nature of whose business calls for special provision.

The general corporation laws usually provide that when due and proper application is made, with payment of the proper fees, the Secretary of State shall issue a charter in accordance with the terms of the application; or, where actual issuance of the charter is not required, the official acceptance and filing of the application authorize, *ipso facto*, the parties to organize as a corporation. In this case the application as approved becomes the charter of the corporation. The persons authorized by the charter to organize, usually meet shortly after its issuance or filing, to elect directors, adopt by-laws, and make the necessary arrangements for the conduct of the corporate business. The procedure for incorporation in the different states varies as to details, and in some few states is materially different from that described herein. In the great majority of states, however, it follows substantially the outline given.

§ 7. Nature of the Corporation

The corporation, when created, is for all practical purposes an individual, having power in its corporate name to carry on business, to make contracts, and to sue or be sued. It is an entity entirely separate and distinct from its

members, who may die or withdraw without affecting the corporate existence. It is subject to the general laws of the land as is an individual, and also to the special state laws made for the regulation of corporations. It must also conform strictly to the provisions of its charter. Its members, called stockholders, may adopt by-laws for its guidance; but these are subordinate to the charter, and both are subordinate to the laws of the state.

§ 8. The Charter

The charter, or certificate of incorporation, is the fundamental law of the corporation, corresponding to the constitution of the state or nation. From it the corporation derives its existence and its powers. All the important features peculiar to a corporation, not secured by common law or necessarily incident to incorporation, should appear in its charter. These are usually the name, purposes, duration, location, capitalization, and the details thereof; also, (in some states), the number of directors, the names of those who are to act for the first year, and any special provisions permissible by law which the incorporators desire to make a permanent part of their organization. Temporary or less important details may be left for by-law or other regulation; but all matters of permanence or importance should, as far as possible, be set forth in the charter.

§ 9. The By-Laws

As already stated, a modern corporation is regulated, first, by the general laws under which it operates; second, by the provisions of its charter; and third, by its by-laws. The by-laws are the quasi-permanent rules of corporate action, and are usually adopted at the first meeting of stockholders. Occasionally, when specially authorized by the charter or by the laws of the state, the directors also have power to pass by-laws.

§ 10. Management of the Corporation

The corporation is managed by a board of directors elected by the stockholders, and subject to the provisions of the corporation's charter and by-laws. The number of directors is often prescribed within certain limits by the state laws—as, not less than three nor more than thirteen—and, within these limits, is fixed by the charter or by-laws. The directors may act only in duly assembled meetings, and their decisions or instructions, usually expressed in the form of resolutions, are carried out by the officers of the company or by special agents appointed by the board of directors.

The officers usually elected by the board are a president, one or more vice-presidents, secretary, treasurer, and sometimes a general manager as well. In the larger corporations assistants to these officers are also elected. The duties of the officers are fixed in a general way by custom, but are varied with the needs of the particular corporation. The by-laws should state clearly the specific duties of each officer. Occasionally, the statutes prescribe some of the official duties, as in New Jersey where the statutes provide that stock certificates must be signed by the president and treasurer of the corporation.

The president of a corporation usually has charge of its general business activities and usually presides at all meetings of stockholders and directors. His powers and duties should be explicitly set forth in the by-laws. The vice-president performs the duties of the president in his absence. Any special duties assigned him should be stated in the by-laws. The secretary has charge of the corporate seal and must affix and attest it when necessary; he usually takes charge of the corporate records and also of the issue and recording of stock. The treasurer has charge of the corporate finances. He signs all checks, sees to their proper

countersigning, and usually participates in the execution of all instruments pertaining to the financial transactions of the company. If a general manager is chosen by the board, he has charge of the general business, manufacturing, mining or whatever it may be, but he is not usually accounted an officer of the company. He is responsible to the directors and usually reports to them.

The profits of the corporate business go to the stockholders in the form of dividends and in proportion to their holdings of stock, at such times and in such amounts as the directors may decide.

§ 11. Capital Stock

The capital stock of a corporation is the amount of stock which the corporation is authorized to issue. Its amount is fixed by the charter and may not be changed except by amendment thereto.

The amount of capital stock as fixed by the incorporators in the charter application may be based, (1) on the actual cash value of property to be taken over by the corporation; (2) on the amount required for the development of the undertaking; (3) on the earning power of the corporate business; (4) on the speculative estimate of what these earning powers will be when the business is developed; or (5) on some combination of these factors.

The statutory requirements as to issuance of capital stock differ in the various states; but some minimum is usually fixed by law as the smallest amount with which the corporation may begin business. Beyond any such required amount, the capital stock need only be issued when it is necessary to secure money or property for corporate purposes.

In a conservative company, the capital stock issued at the time of organization will usually represent dollar for

dollar the amount of cash or its equivalent put into the company; though naturally, thereafter the value of this stock—which depends upon the value of the property of the company—will vary as the corporate business is profitable or otherwise. In a speculative company, on the contrary, the capital stock is usually issued to a figure far in excess of the existing value of any property owned. Nevertheless, if the company is successful, the value of its assets may reach or even greatly exceed its original capitalization.

§ 12. Shares of Stock

The capital stock of a corporation is divided into equal parts called shares, the par value of which is usually \$100, though mining corporations are commonly organized with shares of the par value of \$1, and shares of the par value of \$10 are frequently encountered. The object in issuing these small shares is to encourage small investors. In some states the par value of shares is restricted by law, but in most states it may be fixed at any figure desired. Occasionally shares are issued of the par value of \$500 or even \$1,000 each; but, unless there is good reason to the contrary, a par value of \$100 should be adhered to on account of its common use and its convenience.

§ 13. Stockholders

When a company is organized, its stock is supposed to be issued only for money, property, or something else of value contributed to the company; and the parties who receive the stock in exchange for these values, and those who thereafter acquire it, are the stockholders and compose the company. The number of stockholders in a corporation is rarely less than three. On the other hand, the stockholders may be very numerous; thus the capital stock of

the Pennsylvania Railroad of the par value of \$500,000,000, is owned by over 94,000 different stockholders; and the United States Steel Corporation, with its billion dollars of stock capital, has more than 125,000 stockholders.

When all the stock of a corporation is controlled by one person, it is frequently termed a "one-man company"; or if controlled by a few persons, a "close corporation." Such corporations are common.

The stock of a corporation may be freely transferred by sale or otherwise. Such transfers do not, however, affect the existence of the corporation, which continues until terminated by, (1) statutory limitations; (2) the limitations of the charter; (3) by consent of the stockholders; or (4) by action of creditors. The stockholders of a corporation are frequently in a continual state of change, old stockholders going out and new ones taking their places. The ownership of the corporation is thus continually changing, but the corporation itself is the same. As stated by Blackstone, "A corporation is like to the river Thames, which is still the same river though the parts composing it are changing every instant."

§ 14. Certificates of Stock

The interest of a stockholder in a corporation is fixed by his holdings of its stock. This is evidenced by proper entries on the corporate books and also by certificates signed and sealed by the proper officials of the company, stating the number of shares owned by the individual to whom the certificates are issued. This individual is then the "owner of record." If he sells his stock he assigns his certificates to the buyer, who then surrenders these certificates to the corporation and receives a new certificate in his own name, proper entries being made on the corporate books (§ 61) to show the new owner of record.

All stockholders are entitled to certificates for the stock owned by them, and can under proper conditions force the issue of such certificates if withheld. They are also entitled, within reasonable limits, to have their certificates broken up and reissued if they so desire. To curb too great activity in this direction, the corporate by-laws sometimes authorize the secretary to charge a small fee for each certificate issued by him.

While the stock certificate is the convenient and customary evidence of stock ownership, its loss or destruction does not affect this ownership. Such loss may, it is true, be very embarrassing to the stockholder, just as would be the loss of a deed to real estate; but he is still the "owner of record" on the corporate books, and, though he cannot produce his certificate, is a stockholder of the company, entitled to receive his dividends and to be present and vote at stockholders' meetings. There is, however, one exception to this statement. When a purchaser receives a certificate assigned to him by the seller, and has not yet surrendered it in exchange for a new certificate issued to himself, its loss is far more serious. The seller, and not the purchaser, is then the owner of record, and the purchaser has no stockholder's rights. His only recourse in case of loss under such circumstances is to appeal to the seller and to the corporation for assistance in establishing his true status. This is usually very difficult to establish.

When a stockholder who has lost his certificate wishes to sell his stock, he must apply to the corporation for a reissue; for, speaking generally, no one would buy stock without a transfer of the certificate. The corporate by-laws almost always provide for such reissues, but require the party to whom a certificate is reissued to give bond to protect the corporation in case the original certificate should turn up to its injury.

§ 15. Voting

Each stockholder in a corporation is ordinarily entitled to vote at every stockholders' meeting, and has one vote for each share of stock standing in his name on the books. In an election of directors, for example, he may, for each share of stock owned by him, cast one vote for each director to be elected. Under the plan known as "cumulative voting," which the statutes of some states prescribe, and which in many other states may be obtained by charter or by-law provision, each share of stock still has its one vote for each director to be elected; but, instead of casting this one vote for each candidate, the stockholder may "cumulate" all his votes upon one or more of the candidates, as he sees fit. Thus, if seven directors are to be elected, a stockholder owning one share of stock may, under the cumulative system, cast seven votes for one candidate, or three votes for one candidate and four for another; or may distribute his seven votes among all the candidates as he sees fit.

This method of voting is frequently important to the interests of minority stockholders. Under the ordinary plan they cannot possibly secure representation on the board of directors; but with cumulative voting they can, if they hold a fair proportion of the stock, elect one or more directors. Having representation on the board, minority stockholders are enabled to secure information as to what is being done, and in a measure can protect their interests. (See § 41.)

§ 16. Advantages of the Corporate Form

The corporation as a form of business organization is superior to the partnership in several important respects. A partnership may be formed by word of mouth, by simple agreement, or it may exist by implication without the knowledge of the partners. It is conducted with the same easy simplicity. Each member may act for and bind the partner-

ship, and each member is liable for all the debts of the firm. In suits or other legal proceedings the individual members must be made parties, as the partnership cannot be sued under its firm name.

A corporation, on the other hand, can be formed only by voluntary, deliberate intention of the parties, acting in accordance with statute laws. The management is vested in directors, who must act as a body and in accordance with the regulations of the charter and by-laws. After a stockholder has once paid for his stock, he is not, in most states, liable further for the debts of the corporation. The corporation itself may sue and be sued, and act generally under its own name as an individual.

The more material advantages of the corporate over the partnership form of business organization may be summarized as follows:

1. The limitation of stockholders' liabilities to the amount of their stock (in most states).
2. The distinct legal entity of the corporation for all business purposes.
3. The stability and permanence of the corporate organization.
4. Transferable shares of stock to represent ownership in the corporation.
5. The management of the business by an elected board of directors acting through officers and agents.
6. The greater ease of securing capital under the corporate form because of its safety and its convenient method of representing ownership interests by stock.

§ 17. Disadvantages of the Corporate Form

While the corporation is the best form of business organization, generally speaking, it must not be supposed

that it offers a cure for all business ills, or is a safeguard against all loss. Nor should it be supposed that the partnership form entails all the disadvantages to which business organizations are subject. There are many instances of partnership organizations of long standing under which large and successful businesses have been built up.

Furthermore, while the corporate organization possesses many advantages, it has also its points of disadvantage, in the restrictions and burdens placed upon it by federal and state laws. These include limitations of activity, onerous taxation, the filing of many reports, and the publicity of corporate affairs. There is a strong tendency at present to extend some of these burdens to every form of business organization, but the corporate form is still distinctly handicapped in this respect.

§ 18. Summary of Taxes and Reports

The following summary gives the more important taxes and reports required of corporations. These are in addition to the expenses of organization. Some of the taxes and reports mentioned are not peculiar to the corporation, but are given for the sake of completeness.

Taxes:

1. Organization taxes payable to the state for incorporation.
2. Annual franchise taxes paid to the state of incorporation.
3. Annual taxes on property.
4. Federal income tax.
5. Inheritance tax on stock (in most states).
6. Stock transfer tax (in New York State).
7. Taxes and license fees in each state—outside the home state—in which the corporation does business.

Reports :

1. Local tax reports.
2. State tax reports.
3. Federal tax reports.
4. Annual and other reports required by the home state.
5. Reports in each state—outside the home state—in which the corporation does business.

§ 19. The Corporate Records

The corporation is literally a creature of the law; and, while having no real personal existence, is, apart from its membership, a distinct legal entity, with many of the powers, rights, and privileges of a person. Since corporations are creatures of the law, their business must be conducted in compliance with the law; and this, as well as their distinctive form and method of action, necessitates various instruments, records, and accounts not required by other forms of business organization.

Thus, the proceedings at meetings, both of the stockholders and of the board of directors, must be recorded in suitable minute books; stock certificates must be issued, cancelled and reissued, and these transactions must be recorded in stock certificate books and stock ledgers; the distribution of profits in the form of dividends requires a dividend book, and the issue of bonds requires a bond register.

In addition to the special books and records incident to the corporate form, corporations also require, as business organizations, the usual accounting books and records.

CHAPTER II

KINDS OF STOCK

§ 20. Capitalization

The term "capitalization" ordinarily designates the total capital stock of a corporation, whether common or preferred, issued or unissued; but in economic discussions of finance, this term is frequently extended to include not only the authorized capital stock, but also bonds and similar corporate obligations.

§ 21. Capital Stock and Actual Capital

Capital stock has already been defined (§ 11), but may be further described as the *nominal* or *share* capital of a corporation, as distinguished from its *actual* or *property* capital. These two are radically different. The first is fixed by the charter, while the second is the net value of the corporate assets. The sole effect of the charter provision is to fix the amount of capital stock stated therein as the authorized maximum capital stock; and, while those in control of the new corporation may issue stock up to this amount, they may not exceed it. The property capital of a corporation on the other hand depends entirely upon the corporate business and management. If the corporation is prosperous and if dividends are not declared too freely, its capital will increase; otherwise it will stand still or diminish.

The actual capital of a corporation is usually secured by the sale and issue of its capital stock. In most states this stock may be issued only for cash, property, or labor,

equal at least to the nominal value of the issued stock. Many heavily capitalized incorporations of the past decade have, by various subterfuges, evaded actual compliance with this requirement, but the present tendency towards a stricter enforcement of the letter of the law is making such evasion increasingly difficult.

When capital stock is issued at par for actual value, it follows that at that time the outstanding capital stock and the capital secured by its issue are equal. For example, if a corporation organizes with a capital stock of \$50,000, all of which is issued for money or property, such money or property should represent a value of \$50,000. The capital stock, however, remains a fixed quantity unless changed by formal charter amendment or by legislative enactment, while the actual capital changes with every variation of the corporate business.

The working capital of a corporation is usually understood to include the actual, or property, capital and any money borrowed for business purposes.

§ 22. Shares Without Par Value

In 1912 a law was passed by the New York legislature granting the right, where special application is made therefor, to organize corporations with shares of unspecified value. In such cases, each share of unvalued stock represents an equal interest in the corporation, and each certificate is required to have written or printed thereon the number of unvalued shares represented by it, as well as the entire number of such shares authorized.

For example, if a corporation is organized under the unvalued share law, say with 500 shares, each share would represent a $1/500$ interest in the corporate property and business; and its dollars and cents value could be determined after a valuation of the corporate property and

business, by dividing such value by 500. Thus, if the estimated value of capital and surplus owned by the corporation were \$45,500, each share would, in the absence of other modifying conditions, be worth \$91.* (See § 80.)

§ 23. The Functions of Corporate Stock

The most important function of corporate stock is to indicate the stockholders' interests in the corporation's business. It does not give the individual owner, or stockholder, a right to any part of the corporate capital, except in case of liquidation; but it represents his proportionate part of any profits declared as dividends, and also shows to what representation he is entitled in any meetings of the stockholders.

The division of capital stock into shares enables the interest of each stockholder to be indicated with accuracy, and also permits the transfer of this interest with an ease not found under any other system of business organization.

§ 24. Nature of Stock

From the standpoint of the accountant, the capital stock represents an indebtedness of the corporation, and in practice is entered as a liability on the corporate books and in all statements of corporate affairs. There is, however, a clear distinction between the corporate liability on such things as notes, bonds, outstanding current indebtedness, etc., and the technical liability for corporate stock. No interest is paid on capital stock, nor does the corporation undertake to "pay it out"; and its value, whether face or actual, cannot be collected from the corporation by legal procedure. Therefore it is not, from any point of view, a legal corporate liability. It is only a technical liability, and does not affect the solvency of the corpora-

* For further details see Conyngton's "Corporate Organization."

tion in any way. A corporation may be not only solvent but highly prosperous at a time when its actual assets are materially less than the face value of its outstanding stock.

The capital stock of a corporation, or the assets obtained from its sale, are regarded in law as a trust fund pledged for the payment of the corporate debts. It is the foundation upon which the corporation's credit is based. Hence, both the common and the statute law are insistent that no dividends shall be declared which may impair the capital stock or endanger the solvency of the corporation.

§ 25. Issued and Unissued Stock

A corporation is under no obligation to issue the full amount of its authorized capital stock. On the contrary, after complying with any statutory requirements as to the minimum issue, it may do whatever seems best with the balance of its stock, allowing it to remain unissued or issuing it from time to time as may be necessary or expedient. All "issued stock" which has not in some way come back into the possession of the corporation, is termed "outstanding stock."

Any stock that has not been issued is termed "unissued stock," or sometimes loosely and erroneously called "treasury stock." (See § 27.) Stock on its first issue by the corporation at its organization or later, is termed an "original issue" to distinguish it from stock issued on transfers of certificates, or from treasury stock, etc. Unissued stock has in itself no value, and can neither be voted nor participate in dividends. It is nothing more than a right to issue stock.

§ 26. Full-Paid and Partly Paid Stock

A corporation may sell its stock for any fair price, and

when this price is paid it has no further claim against the purchaser. If, however, this agreed price is less than the face value of the stock, such stock is not full-paid; and should the corporation later become insolvent, its creditors could force the original purchasers of the stock—if it were still in their hands—to pay the difference between the purchase price and the par value, or so much thereof as might be necessary to discharge the corporate obligations. Also, if stock is sold at its full face value payable in instalments, and these have not all been paid, the purchasers are liable to the corporation or to its creditors for the balance due.

If, however, a corporation has once received value in cash, property, or services, up to the face or par value of the stock issued therefor, such stock is termed full-paid. Then, barring the stock of institutions such as banks and trust companies, which are subject to special liabilities, the parties acquiring such stock are not further liable either to the corporation or to the corporate creditors, even though the former should fail and be unable to pay the amounts due its creditors.

The question as to the full payment of stock frequently comes up in connection with its issue for property. If the value of property, or of other considerations given for stock, is not equal to the face value of the stock, the stock is not full-paid; and the corporate creditors may force payment of the deficiency, provided the stock is still in the hands of the original purchasers.

This disquieting liability of partly paid stock is avoided in conservative corporations by issuing stock only in exchange for its full par value in money, property, or labor; while in speculative corporations this object is attained by issuing the stock in exchange for more or less indeterminate property values, optimistically estimated to be equal to the face value of the stock. In former years, if there was any

colorable payment for stock the courts were inclined to hold such stock full-paid; but now, owing to a change of sentiment, the payment for stock is scrutinized carefully, and it must be of fairly equivalent value if liability is to be escaped.

The liability on partly paid stock follows it into the hands of subsequent purchasers if they take the stock with knowledge of the conditions. However, if the stock is marked "full-paid" and is sold to an innocent purchaser for value, he is not further liable; nor, unless so provided by statute, does any liability remain with the seller.

§ 27. Treasury Stock—Donated Stock

The term "treasury stock" is often applied to unissued stock (§ 25) on the assumption that such stock is held in the treasury to be issued as required; but the term is more appropriately used to designate outstanding stock which has, by purchase or otherwise, been acquired by the corporation and is held subject to disposal by the directors.

In speculative corporations the entire capital stock is usually issued for property, and becomes, technically at least, "full-paid." This leaves the corporation without working capital or any means of securing it. To meet this condition, those to whom the stock is issued usually return an agreed part of this stock to the corporation—ostensibly as a donation—to be used for corporate purposes. This "donated stock" then becomes treasury stock and may be disposed of by the directors; and, if the payment was one which will stand legal scrutiny, it may be sold for less than its par value without subjecting the purchaser to the liabilities incident to partly paid stock.

When the preferred stock of a corporation is sold, it is not uncommon to offer with it a bonus of common stock, which, to be attractive, must be "full-paid and non-assess-

able." The corporation must then have for this purpose a supply of full-paid common stock, and this supply usually consists of donated stock as already described. In the ordinary corporation any full-paid stock is non-assessable.

From the accounting standpoint, treasury stock is an asset of the corporation; although it differs from unissued stock only in the fact that it has once been issued and may be sold at less than par without involving the purchaser in liability.

Stock so acquired, or acquired in any other way by a corporation, is usually held in the corporate name, though occasionally it is assigned to the treasurer or to a trustee. When it is to be held in the corporate name, the incoming certificates are cancelled, and the proper entries are made in the stock book to show that the stock has been transferred to the corporation. It is not necessary, however, to issue new certificates so long as such stock is held in the treasury; but when sold, a new certificate is issued to the purchaser.

When its own stock is owned or held by the corporation, this stock can neither vote nor draw dividends.

§ 28. Common and Preferred Stock

When all the stock of a corporation is on an absolute equality, it is known as "common stock." No one stockholder then has any rights over any other stockholder, and no one share of stock has any advantage over any other share.

If, however, by proper procedure—usually by charter provision—some of the stock has been given rights as to dividends or assets not enjoyed by the other stock of the corporation, such stock is "preferred stock" as opposed to the remaining or "common stock."

Preferred stock can be created by proper procedure in

any state of the Union. In some states it is created by charter provision; in others, through by-law enactment, or by direct and unanimous action of the stockholders.

Speaking generally, preferred stock, in addition to its preferential rights, has all the rights and liabilities of common stock. In other words, preferred stock loses none of the rights of common stock by reason of its preference, unless such rights are expressly denied or restricted by the same authority that created its preferential rights. The entire trend of modern decisions involving preferred stock is to consider it as merely common stock with certain specified additional privileges.

As already stated, stock is not a real but only a secondary liability of the corporation; and unless otherwise expressly provided by statute, this is equally true of preferred stock and also of its preferred dividend. Such preferred dividend, or interest as it is sometimes incorrectly called, may be paid only out of profits, and is not a debt of the corporation until such profits have been earned and declared as dividends.

As to the form of preferred stock, different classes may be created by the same corporation; one class may receive its dividends before the second, the second before the third, and both these may receive their dividends in any year before the common stock receives any dividend at all. These several classes may have different dividend rights, one receiving perhaps 5% and another 6%. Sometimes the amount of preferred dividend will be made contingent upon the amount of profits; or the corporate income from particular sources may be designated for payment of preferred dividends; or preferred stock may be given preference in the distribution of assets, or other special redemption features may be given, or it may be made convertible into common stock under prescribed conditions. (See § 30.)

On the other hand, privileges or rights may be denied.

Thus, preferred stock may be denied the voting right, or else permitted to vote only under certain conditions. Dividends may be made non-cumulative, or such stock may be strictly limited to the preferential dividend. Preferred stock is held to be cumulative as to dividends unless it is specified that it shall be non-cumulative. (See § 29.)

The usual reason for the issue of preferred stock is to provide a corporate security which can be sold more readily than the common stock. Its numerous possible variations, however, render it available for many different purposes. Thus, preferred stock is frequently issued to represent or pay for the actual property assets taken over by a new corporation, while common stock is issued to represent the good-will and other intangible assets. Or, when a partnership is incorporated, the excess investment of one partner is frequently represented by an issue of non-voting preferred stock, while the interest of the silent partner is conveniently cared for by the same means. In a consolidation of properties, the interests of those concerned are equitably adjusted with the help of preferred stock.

From the standpoint of the corporation, preferred stock is usually more desirable than bonds as a means of raising money. It does not become a debt either as to dividends or principal. Unless the stock is redeemable, the principal is never due. The dividend is paid if profits exist for its payment; but, if the dividend is not paid in any year, it merely passes over to succeeding years if cumulative, or expires if non-cumulative. In any event, it is only a claim against profits. Bonds, on the other hand, are an absolute obligation both as to interest and principal. If the interest is not paid when due, it may be collected by legal proceedings, and frequently default in interest has the effect of maturing the bond and thereby rendering payment of both principal and interest imperative. In any event, the bond must be paid at

maturity under penalty of foreclosure, regardless of the condition of the corporate finances.

§ 29. Dividends on Preferred Stock

Dividends on preferred stock are either cumulative or non-cumulative. A cumulative dividend is one which, if not paid in any year, becomes a charge against the future corporate profits, and cumulates from year to year until paid. A non-cumulative dividend is one which is a first charge on any profits declared as dividends in that particular year, but, if no dividends are paid in that year, does not continue as a charge against the profits of following years.

Where cumulative preferred stock exists, no dividends may be paid upon the common stock in any year until the preferred dividend for that year has been paid in full, together with any preferred dividends not paid in preceding years. Thus, if preferred stock bears a 6% cumulative dividend and no dividends are paid the first year, the common stock cannot receive any dividends in the second year until the preferred stock has received a 12% dividend. If no dividends are paid in the second year, the preferred stock must receive a full 18% in the third year before the common stock may receive any dividend.

It is obvious that a cumulative dividend is the more advantageous to the holder of preferred stock. In fact, non-cumulative preferred stock offers a temptation to the directors interested in the common stock, to pass dividends. Thus, if in any year sufficient profits exist from which the preferred dividends might be paid, but the directors refuse to declare dividends until the following year, the preferred dividend that might have been paid in the preceding year is lost absolutely to the preferred stockholders and its amount is saved to the corporation and may be declared as dividends the next year or at some later time at the discretion of the

directors. In these dividends from held-over profits, the preferred stock will participate only to the amount of its preferred dividend for that single year, the entire remainder of the dividends declared going to the common stock.

When it is not specified that preferred stock shall be non-cumulative, it is held to be cumulative.

§ 30. Convertible Stock

Preferred stock, in order to make it more salable, is sometimes issued with the right of exchange for common stock, either at some specified time or within a specified period; the terms of exchange being prescribed and usually appearing upon the face of the certificate. When preferred stock is non-participating, i.e., does not participate in profits beyond its preferential dividends, the convertible privilege adds materially to its attractiveness. Its preference as to dividends—and as to assets if this also belongs to it—gives it a safety and an assurance of annual returns that is not characteristic of common stock, while the convertible feature gives an opportunity for an advantageous exchange for common stock if the corporation is so prosperous as to make this exchange desirable. In other words, the convertible stock offers the safety of preferred stock with the speculative possibilities of common stock.

Sometimes this convertible feature exists between preferred stock and bonds, as in the case of the United States Steel Corporation's 7% preferred stock, which is exchangeable for its 5% bonds. Any such exchange of stock for bonds or agreement for such exchange would usually be illegal. In effect it amounts to a corporation's borrowing money to buy its own stock. The exchange in the case of the United States Steel Corporation was made pursuant to provisions of a special enactment of the New Jersey legislature, and a large amount of preferred stock was replaced

by the bonds; the exchange converting a 7% cumulative dividend into a 5% interest obligation.

When preferred stock is convertible into common stock the corporation must make provision for the exchange, reserving unissued stock, or purchasing its outstanding stock, or perhaps increasing its capital stock sufficiently to meet the requirements of the exchange.

§ 31. Guaranteed Stock

The term "guaranteed stock" is sometimes applied to preferred stock, and in such case usually designates a stock on which the dividends are guaranteed by the terms of the creating provision. There is no special virtue in the expression or in the stock, as it is held ordinarily to be merely cumulative preferred stock. In spite of the statement of the creating provision that the dividend is guaranteed, such dividend can be paid out of profits only, and if no profits exist it is in no way a debt of the corporation. Any unpaid dividends merely pass over and cumulate as a charge against profits.

The usual and better application of the term "guaranteed stock" is to stock which, as to dividend or principal, or both, has been actually guaranteed by some person, concern, or corporation other than the issuing corporation. Such stock is frequently created when a railroad takes over a subsidiary line, and guarantees either dividends or principal, or both, on the stock of the absorbed road. The dividend on the guaranteed stock then becomes an actual obligation of the guaranteeing company, which must be met when due just as in the case of any other interest or obligation.

§ 32. Watered Stock

"Watered stock" is merely a term used to designate any fictitiously paid-up stock; that is, "stock which is issued as

fully paid-up stock, when in fact the whole amount of the par value thereof has not been paid in. All stock which has been issued as paid-up stock, but the full par value of which has not been paid into the corporation in money or money's worth, is watered to the extent that the par value exceeds the value actually paid in. Watered stock is, accordingly, stock which purports to represent, but does not represent, in good faith, money paid into the treasury of the company, or money's worth actually contributed to the capital of the concern."*

Watered stock arises from many conditions. In speculative corporations the stock is usually issued in exchange for property at enormously inflated values. A railroad, the issued stock of which is perhaps already in excess of the real value of its property, finds its dividends so uncomfortably large as to attract public attention. Then, entirely regardless of the real values behind its stock, it will add a few millions to its capitalization and "cut a melon" for the benefit of its stockholders. Or, in a combination of producing properties, preferred stock will be issued for the actual property values, and common stock be issued in addition up to the full measure of the earning power of the combination. Thus, if a combination is formed of properties of the actual value of, say, \$5,000,000, with estimated net profits of \$600,000, the combination can pay a 6% dividend on a capitalization of \$10,000,000. \$5,000,000 face value of preferred stock is then issued for the properties, and an equal amount of common stock is issued against the good-will or earning power of the corporation. This is obviously watered stock.

The expression "watered stock" is usually a term of reproach, but it is clear that under some circumstances such stock is justifiable. A going concern may be incorporated.

*Cook on Corporations, § 28.

The value of its property is \$50,000; and its record, based on its earnings for a number of years, shows that it can pay dividends on a capitalization of \$75,000. \$25,000 of stock is therefore added to the property values, making the total capitalization of the concern \$75,000. The \$25,000 of stock issued in excess of the property value is technically watered stock, but no one will contend that it is not a justifiable and entirely proper issue.

Watered stock that is to be condemned is found when capitalizations are increased far beyond the value of the property and beyond any earning power possessed by the corporation.

CHAPTER III

MEETINGS; THE CORPORATE CALENDAR

§ 33. The Annual Meeting

The annual meeting of stockholders is their only *regular* meeting, i.e., one of which the date and the general nature are fixed by the by-laws, and at which any ordinary corporate business may be transacted without special mention in the notice of the meeting. All other stockholders' meetings are *special* meetings, assembled as the necessity arises for the transaction of special business which must be specified in the notice of the meeting.

Certain matters relating to, or to be done at, the annual meeting are prescribed by statute in many states; and these statutory requirements are, together with other matters of procedure, usually set forth again in the by-laws of the company. The more common matters of statutory and by-law regulation are: the place of meeting; requirements as to its notice; the closing of the stock books; the preparation of a list of stockholders for use at the meeting; the formalities incident to the election of directors; the reports to be presented; etc.

Considerable laxity in the formalities of the annual meeting usually obtains in the smaller corporations. Not infrequently, where the stockholders of the corporation are few and all are officers of the corporation or are actively engaged in its business, the election of directors and even the annual meeting itself are dispensed with, the existing board of directors continuing in office until a new board is elected. Such laxness, while permissible where all the

stockholders concur, is to be deprecated. It is better that everything pertaining to corporate management should be carried out in strict accordance with the statutory, charter, and by-law requirements.

§ 34. Time of Annual Meeting

Corporations usually hold the annual stockholders' meeting shortly after the close of their fiscal year, which may or may not coincide with the calendar year. Usually, it is preferable to have the fiscal year close with the 31st of December, but conditions sometimes exist which make it advantageous to fix the date otherwise, as for instance at a time when business is slack and the stock of goods low. It is easier at such times to take inventories, close books, and prepare reports; also plans and policies for the succeeding year may be mapped out then without the serious interruptions to the immediate business activities that would occur if the fiscal year closed at a busier time.

The annual meeting should not be held too closely after the end of the fiscal year. If the fiscal year ends December 31, the annual meeting of stockholders might be held during the second or third week in January, so as to give ample time to close and audit the books, prepare financial statements, and compile the other data needed for the annual reports.

The time of the annual meeting is prescribed in the by-laws.

§ 35. Preliminary Arrangements for Annual Meeting

In arranging for the annual meeting certain formalities, usually prescribed by the by-laws, must be observed, such as the due notification of stockholders, the closing of transfer books, etc. Some of these are statutory requirements. It is the secretary's duty to carry out most of these preliminary

requirements of the meeting, and at the time of the meeting to see that everything needed is ready and accessible.

§ 36. Annual Meeting—Closing Transfer Books

The "closing" of the transfer books means nothing more than that the officer in charge of the books in which the transfers of stock are recorded refuses to make entries in them during the period they are closed. Stock may be bought and sold just as before, these transfers being evidenced by the properly assigned certificates, but such transfers cannot be recorded on the books of the corporation, nor will new certificates be issued until the books are "opened" for transfers.

The by-laws of most corporations, especially of those whose stocks are listed on exchanges, specify that the transfer books shall be closed a stated number of days before the annual meeting. Notice must be given by the secretary before the time of closing. All stockholders of record, i.e., those whose stock ownership is of record on the corporation's books on the date of closing, are entitled to participate in and vote at the annual meeting. No other persons are so privileged, unless they hold proxies from stockholders of record.

The object of closing the books is to give the secretary opportunity to give due notice of and make his preparations for the meeting; also to prevent any sudden or unforeseen transfer of stock with a view of controlling the election. In small corporations, where the stock is not active, the closing of the stock book before the annual meeting is not usual. (See § 62.)

§ 37. Annual Meeting — Stockholders' List; Notices; Proxies

The statutes, and the by-laws as well, usually require

that an alphabetical list of stockholders be prepared for inspection and for use at the annual meeting. This list is prepared by the secretary after the transfer books are closed, and shows the persons who are stockholders of record and entitled to be present and vote at the meeting. Whether required or not, it should be on hand for reference at the meeting and should be open to the inspection of any stockholder.

Notice of the annual meeting should be given to all stockholders of record, either by letter or by advertisement in the newspapers. The by-laws usually prescribe the method of notification and the number of days prior to the meeting that notice shall be given, and, when the notice is by letter, sometimes require that these letters shall be registered to insure safe delivery. The notice of meeting gives the dates for the closing and the opening of the transfer books. Copies of papers in which the advertisement appears should be carefully preserved by the secretary as a matter of record.

The notices sent out to the stockholders usually contain printed proxy forms. Stockholders unable to be present in person are asked to sign and send in these proxies, which authorize some person—usually the secretary of the company—to vote their shares. By this means a quorum—which is necessary for the transaction of business—is sometimes secured when otherwise it could not be done. Also, at times these proxies enable the directors in office to retain their positions. (See Appendix, Form 5.)

§ 38. Annual Meeting—Quorum

A quorum at a stockholders' meeting, i.e., the number of shares of stock which must be represented in person or by proxy before business can be legally transacted, is ordinarily stated in and fixed by the by-laws. The usual requirement

is a majority of the outstanding stock, except at those meetings where some special action is to be taken or where for other reasons the amount or proportion of stock to constitute a quorum is fixed by the state statutes. Thus an amendment of the charter usually requires the action of more than a mere majority of the stock and in New York the statutes contain the very unusual provision that whatever amount of stock is present at a properly assembled annual meeting constitutes a quorum, and may elect directors and transact any other business properly before the meeting. The number of persons present at a meeting is of no importance. One person may by ownership of stock or by proxy, or both, represent a controlling interest or even the entire stock; and such a meeting if properly conducted is legal, though in England and Canada it has been held that it takes at least two to hold a meeting.

It is the secretary's duty, in calling the roll, to note whether or not a quorum is present and to report the fact to the president. No business can be transacted if a quorum is not present. If a quorum is present the fact should appear in the minutes.

§ 39. Annual Meeting—Opening Formalities

If the by-laws so provide, the president and secretary of the company act in their official capacities at the annual meeting; if not, the president must call the meeting to order and the stockholders at once elect a chairman. A secretary of the meeting is then either appointed by the chairman or by vote of the members present. After the chairman and secretary have been elected, the secretary, upon request of the chairman, calls the roll.

After the roll call, a copy of the notice of the meeting as sent to the stockholders, or a copy of the newspaper containing the notice of the meeting, should be presented

and read by the secretary, and a record of the same should be made in the minutes.

The minutes of the previous annual meeting and usually of any intervening special meetings, are read by the secretary as the next order of business. If any changes in the minutes are found necessary, they must be made by means of motions duly seconded and passed. Such changes are usually made by interlining—the amended material being crossed out with red ink—or by marginal annotation; or, if the new matter is too lengthy for this, it is brought in at the end of the minutes, a note against the amended portion telling where the amendment may be found.

§ 40. Annual Meeting—Election of Directors

One of the most important matters coming before the annual meeting of stockholders is the election of new directors to serve for the ensuing year or term. If there are many directors, the term of office may extend over a number of years; and in this case the membership of the board is so arranged that a majority always holds over. For instance, in a board of fifteen directors it might be arranged for the terms of five to expire each year, the new directors being chosen to serve for the ensuing three years. The advantage of this method is found in the fact that a majority of the board will always consist of experienced directors.

The election of directors is usually by ballot and is conducted by judges or inspectors of election. These judges or inspectors—generally two in number—may or may not be stockholders unless fixed by statute or other authority. In some states the statutes require that the inspectors be sworn to the faithful discharge of their duties before a notary or other person qualified to administer oaths.

In the absence of statutory requirements, the election of

directors becomes a very simple matter. Nominations are usually made in advance, and either the secretary or tellers appointed for the purpose distribute, collect, and count the ballots. The result of the election is then announced and the successful candidates are formally declared elected.

§ 41. Annual Meeting—Cumulative Voting

Cumulative voting is a method of voting for directors which permits of such cumulation or concentration of votes that the holders of less than a majority of the stock may by proper combination elect one or more members of the board; this under the ordinary method of voting being impossible. Representation on the board is advantageous to the minority stockholders because it enables them to keep more fully informed as to the general affairs of the corporation, and more particularly as to any official action contemplated or taken by the board. If any such action seems to them injurious or illegal, their prompt knowledge of what is done gives them an opportunity to protest or to take any legal action that may be necessary.

Cumulative voting is prescribed in some states by constitutional or statutory provision. In most of the states it may be secured, when desired, by charter or by-law provision.

The cumulative method of voting is merely a modification of the usual plan of voting. Ordinarily every share standing in the name of a stockholder on the books of the corporation entitles him to one vote for each of as many directors as are to be elected. For instance, if a board of five directors is to be elected, the owner of one share may cast one vote for each of five candidates; in other words, he must divide his five votes among the five candidates, one to each. Under the cumulative method, he still has his five votes and may still divide these five votes among five can-

didates; but if he prefers, he may cast them all for one candidate, or divide them among two or more as he sees fit.

To illustrate more fully, suppose a company with a board of five directors has 100 shares of stock outstanding, 70 shares of which are held by parties who vote together and constitute a majority; and 30 shares held by the minority stockholders who likewise vote together. Under the ordinary system of voting, the five candidates favored by the majority would each receive 70 votes and be elected, while the minority candidates could receive only 30 votes each and would fail. Under the cumulative system, however, the majority having 350 votes (70×5) could give five candidates 70 votes each; while the minority having 150 votes (30×5) at their disposal, could divide them between two of their candidates and, if the majority voted in the manner suggested, would elect both of them. The majority would then have three members of the board, while the minority had two.

In such a case, however, the majority would undoubtedly divide their 350 votes among four candidates, giving, say, two 87 votes and two 88 votes, which would unfailingly elect the four candidates; and the minority could elect but one member of the board, but could not in any way be prevented from electing this one member.

The number of votes available under the cumulative system of voting is found by multiplying the number of shares by the number of directors to be elected.

§ 42. Annual Meeting—Reports

Reports of officers and committees as prescribed by the by-laws are presented at the annual meeting. The usual reports are the president's report of general conditions and the treasurer's report of financial conditions. Any committees appointed by the stockholders at preceding meet-

ings will, as a matter of course, report at the annual meeting, and any other special reports covering matters of interest to the stockholders might also be read at this meeting. (See Part V, "Corporate Reports and Statements.")

§ 43. Annual Meeting—Minutes

When there is no further business to come before the meeting, it is adjourned. As soon as possible thereafter the secretary should write up his minutes while the details of the meeting are fresh in his mind. The minutes of the annual meeting, as of any other meeting, should be a complete and accurate statement of the procedure at the meeting. They should give the place and date of meeting; copy of the notice given; the name of the presiding and of the recording officer; the attendance, i.e., the amount of stock represented, and whether it constitutes a quorum; and should follow this with a brief but accurate statement of all business transacted at the meeting. When matters passed upon are of but little importance, the exact wording of the motion or resolution need not be brought into the minutes, but merely a statement of the fact that such a motion was made and carried or not carried, as the case may be. Where, however, the matter is of importance, it is usually advisable to embody in the minutes the exact wording of the motion or resolution, with the names of the parties who respectively introduced and seconded it. In matters of great importance the names of those voting for and against are usually recorded.

Any important reports or other matters presented to the meeting should be noted, and if in writing should, when so ordered by the meeting, be "spread on the minutes," i.e., written out in full; but otherwise it is quite sufficient merely to refer to the matter in the minutes. The secretary will, of course, in all cases preserve the reports or other papers.

The minutes of any meeting should be signed by the secretary and, if possible, by the presiding officer of the meeting. (For forms of minutes, see Appendix, Forms 4 and 7.)

§ 44. Directors' Meetings

Meetings of directors, as in the case of stockholders, may be regular or special; regular meetings being usually monthly or quarterly. The notice of all meetings of directors, whether regular or special, is sent out by the secretary, the requirements for such notice being prescribed by the by-laws.

The president of the company is the presiding officer at all board meetings unless otherwise specifically provided in the by-laws. The secretary is the recording officer.

At a directors' meeting the quorum is fixed by the by-laws and is not infrequently less than a majority of the board. Absent members *cannot be represented by proxy*. In other words, if a member of the board is unable to be present, his vote is lost absolutely. This is because the stockholders have elected the directors to represent them, and these directors cannot pass this delegated power on to someone else.

The general procedure at directors' meetings and the duties of the secretary are much the same as in the case of stockholders' meetings. The directors' minutes are sometimes kept in the same book as the stockholders' minutes, but are frequently kept in a separate book. Where they are kept in the same book, they either follow seriatim as the different meetings are held, or one part of the book may be kept for the minutes of the stockholders' meetings and another part of the book for the minutes of the directors' meetings; the matter usually being left to the secretary to decide.

As soon as possible after the annual meeting of the stockholders the directors usually meet for the election of officers, any newly elected directors participating in this meeting.

§ 45. Special Meetings

Special meetings, as distinguished from regular meetings, are meetings called to transact special business as required, and on such notice as is prescribed by the by-laws. Calls for special meetings are sent out by the secretary, and must be authorized as prescribed by the by-laws; the authorization is usually, in the case of special meetings of stockholders, by the board of directors, the president of the company, or a certain proportion of the stockholders; or for special meetings of the board, by the president or a certain number of the directors. The secretary's call usually states by what authority it is issued, and must announce the time and place of the meeting and the matters to be considered at that meeting, and only such business may be transacted as is stated in the call. If other business should be transacted, any parties aggrieved thereby could, if the injury were real, have such action of the meeting annulled.

The officers of a special meeting of stockholders and the general procedure thereat are much the same as in the case of a regular meeting. It may be noted, however, that as the legality of a special meeting depends largely upon the legality and proper form of the call and notice by which it is assembled, this call and notice is of much greater importance than the notice of a regular meeting; and the particulars in regard to it, together with the call and notice itself, should be entered in detail upon the minutes.

§ 46. The Corporate Calendar

The corporate calendar is in effect a tickler, containing memoranda of the important corporate events of the year,

arranged chronologically under the dates on which they occur. By consulting his calendar the secretary can determine at any time what official details require attention on that or any future date.

This is particularly important for the secretary, because on him devolves the responsibility for all notices and other preparation for meetings, and usually for the reports required by state or local regulations and for other corporate matters requiring attention on fixed dates. The calendar may be arranged in order of dates on a convenient card, or noted on an ordinary calendar. In either case it should be hung in a conspicuous place for ready reference so that no important detail shall be overlooked. All details recorded on the calendar should, of course, be accurate.

§ 47. Contents of Corporate Calendar

The corporation calendar which follows is that of a New York corporation. As the matters to be attended to and the dates on which they come up vary with the different states and the different corporations, the calendar given can only be regarded as suggestive. The secretary must determine in each case what shall be recorded. The following matters, among others, and the dates on which they require attention, should be carefully noted:

- Closing of transfer books

- Notice of annual meeting

- Preparation of alphabetical list of stockholders

- Annual meeting

- Notice of directors' meetings

- Directors' meetings

- Dividend dates

- Dates for paying bond interest

- Dates for making reports

- Dates for payment of taxes

§ 48. Form of Corporate Calendar

CORPORATE CALENDAR
OF THE
HUDSON RIVER PACKING COMPANY
OF NEW YORK CITY
1916

January

- 1 *Franchise Tax Payable.* Must be paid before January 15. (Based upon November report to State Comptroller. Statement of amount of tax is sent to Company by State Comptroller. Checks should be made payable to State Treasurer.)
Federal Income Tax Report. Must be prepared and filed with Collector of District before March 1 (unless a date other than December 31 has been designated as the close of the fiscal year).
- 3 *Notify Stockholders* of annual meeting to be held January 13.
- 9 *Notify Directors* of meeting to be held January 14. (If directors are elected at annual meeting, January 13, this notice will be viated as to all directors elected at such meeting and must be replaced by waiver of notice signed after election by all the newly elected directors.)
- 13 *Annual Meeting* of stockholders at 3 P.M.
- 14 *Directors' Meeting* at 4 P.M. (If directors were elected at annual meeting, waiver of notice should be signed by each new director.)
- 15 *Last Day* for payment of State Franchise Tax.
City Taxes. On this date unpaid city tax bills for personal taxes may be sent to the City Marshall for collection.
- 17 *Annual Report* to State officials. Must be filed during January and not later than January 31 with Secretary of State. (No filing fees. Blanks not supplied by officials. No penalty incurred for omission of the report unless such filing is requested by some stockholder or creditor of the company, and not then if the report is filed within thirty days after the request is made.)
- 31 *Last Day* for filing annual report.

March

- 1 *Last Day* for filing Federal Income Tax Report.

April

- 9 *Notify Directors* of meeting to be held April 14.
- 14 *Directors' Meeting* at 4 P.M.

June

- 1 *Assessment of Federal Income Tax made.*
- 30 *Last Day to pay Federal Income Tax.*

July

- 9 *Notify Directors of meeting to be held July 14.*
- 14 *Directors' Meeting at 4 P.M.*

October

- 2 *City Assessments made for next year. Books open for correction till November 10 inclusive. (If notice of assessment is not received in the early part of October, it should be sent for. Tax Commissioners usually send notice but are under no obligations to do so.) If assessment is unsatisfactory, sworn statement of correct value of assets must be prepared and filed. (See memo. for November 10.)*
- 4 *City Taxes Payable for current year. (Statement of amount is usually sent to all corporations, but may be obtained from Assessor's office if copy is not received.)*
- 7 *Notify Directors of meeting to be held October 13.*
- 13 *Directors' Meeting at 4 P.M.*

November

- 1 *Comptroller's Report. Must be sent in on or before November 15. (Blanks furnished by, and report made to, State Comptroller. No filing fees. Penalty may be incurred by failure to make this report.)*
- 10 *Statement and Application for revision of unsatisfactory city assessments, if not already filed, should be sent in to the Commissioner of Taxes and Assessments. Will not be received after November 30 save for real estate. (Blanks furnished by Commissioners. No filing fees.)*
- 30 *Last Day for filing application for revision of city assessments, save on real estate, which may be revised at any time before payment of the tax.*

December

- 22 *Close Transfer Books for annual meeting of January 11, 1917.*
- 28 *Publication Notice of Annual Meeting. Notice of meeting to be held January 11, 1917, to be published in newspaper of New York County once each week for two successive weeks immediately preceding the annual meeting.*

Part II—Corporation Records and Accounts

CHAPTER IV

THE BOOKS AND RECORDS OF A CORPORATION

§ 49. Books of Account

The books of account for the ordinary corporation are similar to any other books of account, save as to the entries for distinctive corporate transactions. All the records and accounts peculiar to corporations are discussed in the present volume; but for the character and use of the books relating to the ordinary commercial transactions the reader is referred to any text on accounting.

§ 50. Requirements

The general books of a corporation differ little from those of a partnership or a single proprietorship conducting a similar line of business. In a corporation, however, there is, in addition to the financial books of account which record the transactions of ordinary business, another class of books, such as the minute book, stock book, dividend book, bond record, etc., for recording the activities peculiar to the corporate form. So necessary are these books that in many states the laws specify that certain of them, as the minute book, stock book, transfer book, etc., shall be kept. There are, therefore, in corporate bookkeeping, books and accounts not found in the records of the partnership or the single proprietorship.

The distinctive books of record to be kept by a corporation are frequently set forth in its by-laws; although the books so enumerated would usually be kept as a matter of course by any well-managed corporation.

Under these conditions the accountant, when devising an accounting system for a corporation, must first consult the statutes of the state to ascertain the legal requirements. Frequently the statutes not only prescribe certain books, but also specify where these books must be kept and what they must contain. Next, he must consult the by-laws of the corporation to ascertain their requirements as to books and records. Then, in addition to the books required by the laws and the corporation by-laws, he must add such other books as are needed to make a complete record of the financial transactions of the corporation.

§ 51. Inspection of Corporate Records

Stockholders usually have, within limits, the right to examine the corporate books. This right extends much further as to official records, such as the stock ledger, etc., than as to the books of account. The stockholder's right to examine the latter is usually much restricted and in some states denied entirely. In the State of New York, for example, every corporation must keep a stock book in prescribed form, and this book must be open for inspection by the stockholders at least three hours daily. A penalty of \$50 a day is imposed upon the corporation and upon the particular official for failure to comply with this requirement. On the other hand, in this same state, the stockholders' right to inspect the books of account is practically nil. A director, however, has the absolute right at any time to examine the books of account as well as the other corporate records, and this is true in practically all the states. This is part of his duties as director.

§ 52. Corporate Books of Record

The distinctive corporate books include those in which are entered the official acts and resolutions of the directors and stockholders, and also those which contain detailed records of transactions pertaining to stock and bond issues, dividends, etc. The books of official record and the various stock books are usually kept by the secretary. The financial records relating to the sale of stock and bonds are usually under the supervision of the treasurer or are kept in the accounting department of the corporation, as are also the bond register, the dividend book, and other records which pertain more directly to the corporate finances.

The usual corporate records include :

- Minute book (§ 53)
- Subscription records (§ 55)
- Instalment receipts (§§ 56, 57)
- Instalment book (§ 58)
- Stock certificate book (§ 60)
- Stock transfer book (§ 62)
- Register of transfers (§ 63)
- Stock ledger (§§ 65, 66)
- Dividend book (§ 67; Chapter IX)
- Bond register (§ 211; Chapter XVI)

This number might be extended considerably, and subdivisions made, especially in the case of large corporations. On the other hand, in the case of a small company some of the enumerated books would be omitted entirely. Indeed, in some companies, especially where the stock is held by a few individuals, the bookkeeping is as informal as in a partnership and but few of the distinctive corporate records are kept. It is, however, a wise precaution always to provide for the proper record of all corporate transactions, no matter how small the corporation or how closely its stock

may be held. If this is not done, trouble may result; "an ounce of prevention is worth a pound of cure."

All the books enumerated above are auxiliary books, i.e., they are not used as posting mediums for the general books; but are subordinate thereto.

A book known as a "combination record" is frequently used by the smaller corporations for the distinctive corporate records. This book is divided into parts, each of which takes the place of the more important of the distinctive corporate records mentioned above. If the forms included in it are good, the combination record will be found convenient for the ordinary small corporation. For the larger corporation it is not suitable.

§ 53. The Minute Book

The minute book is used to record the proceedings at meetings of stockholders and directors. At the present time the usual form of minute book is a loose-leaf book, in which the minutes may be entered with a typewriter. Under this system, to guard against substitution of pages after the minutes are written up, each separate sheet should be signed by the secretary and, in the more expensive books, each sheet is specially numbered on watermarked paper, so that substitution is practically impossible. The convenience of the loose-leaf minute book is obvious.

In large corporations separate books are kept for the stockholders' and directors' minutes, but in the smaller corporations the minutes of all meetings are usually entered in one book. In such case, either the first part may be allotted to the meetings of stockholders and the latter part to the directors' meetings; or, as is done more frequently, the minutes of the various meetings may be entered one after the other as they occur. Under this arrangement, the first minutes to appear in the book would in most cases be those

of the first meeting of stockholders. These would be followed by the minutes of the first meeting of directors; and thereafter the minutes would come in the order in which the different meetings were held. As the stockholders usually meet but once a year, and the directors much oftener, the minutes of the stockholders' meetings will then be separated by the more numerous minutes of the intervening directors' meetings.

A copy of the charter of the corporation is often bound into the minute book, forming its first pages; or, where this is not convenient, the charter is copied or pasted on the first pages of the minute book. Following the charter, a page or more is usually allowed for the entry of charter amendments. Next, beginning at the top of a right-hand page, the by-laws of the corporation are entered, the next few pages being left blank for new by-laws or any amendments too long to be interlined in the by-laws themselves. Finally, in the body of the book come the minutes of the various meetings.

Minutes should be entered in the minute book as soon after the meeting as possible. The minutes of each meeting should begin at the top of a new page; and the character of the meeting, i.e., whether a stockholders' or directors' meeting, and whether regular, special, or adjourned, should appear clearly in the heading. The date also should appear prominently. In the body of the minutes it should be stated how the meeting was called; whether a quorum was present; the names of the presiding and recording officers; the time at which the meeting convened, etc.

The minute book is one of the most important of the corporate records. The minutes are the officers' authority for many of their most important acts and from these same minutes the accountant gets his data for many of his most important entries. The necessity for complete, accurate

and properly evidenced minutes is obvious. Complete forms of minutes will be found in the Appendix (Forms 4 and 7). It is the duty of the secretary to keep the minutes of meetings.

§ 54. Stock Subscriptions

Subscriptions to stock are *not binding upon the subscribers until accepted by the corporation*, or by an authorized representative or trustee of the corporation. Until such acceptance, there is no second party, and under such circumstances a subscription is merely an offer to take stock, which can be rescinded or revoked by the subscriber at any time. Indeed, in some cases where subscriptions have been accepted by an organization committee, it has been held that the subscriber might cancel his subscription at any time before the actual incorporation. Where, however, an organization committee incurs some expense in connection with a proposed incorporation, it is doubtful whether subscribers who are fully aware of such expenditure can be relieved from their proportion of these expenses by a revocation of their subscriptions.

In some states, all the capital stock must be subscribed before incorporation, and in some other states a specified proportion or amount must be subscribed before the corporation may be organized. In such cases, subscriptions are usually not payable until the amount required by the statute has been subscribed.

Full-paid stock is sometimes issued in exchange for services, for property, or for other considerations; and it is not uncommon for subscriptions to be paid by promissory notes. In the State of New York, however, corporation officials are prohibited under heavy penalties from accepting notes in payment of stock subscriptions; but such payments, if in good faith, would be valid in most states.

§ 55. The Subscription Book or List

Subscription books are seldom used in this country, except, perhaps, for collating and recording subscriptions after the subscribed lists have been turned in. The subscription list usually consists of a sheet or sheets of paper with suitable headings, on which subscribers to the stock of the company enter their subscriptions. At times, several different subscription lists are circulated simultaneously, and in this case the sheet form is, of course, employed. Subscription lists are seldom used in floating small corporations; but for larger ones, or where subscriptions are solicited, they are necessary.

The following forms illustrate some of the subscription blanks and agreements in ordinary use:

SUBSCRIPTION LIST

DAVISON MERCANTILE COMPANY

To Be Incorporated Under the Laws of New York

Capital Stock \$200,000

Shares \$100 each

We, the undersigned, hereby severally subscribe for and agree to take at their par value, the number of shares of the capital stock of the Davison Mercantile Company set opposite our respective signatures, said subscriptions to become due as soon as said Company is organized, and to be then payable in cash on demand of the Treasurer of the Company.

New York City, New York,

April 5, 1916.

Names	Addresses	Shares	Amounts
A. W. Davison	235 West 80th St., New York	800	\$80,000
George H. Brandon	846 York Ave., New York	300	30,000
R. S. Cooke	164 King St., Brooklyn, N. Y.	200	20,000
James Robinson	Jersey City, N. J.	200	20,000

Subscription List

This form is satisfactory when only a few persons are concerned, and when the purposes of the company and conditions of subscription are well known. In this case subscriptions are not payable until the organization is completed. At the same time, it is obvious that money to pay the incorporation fees must be raised before the charter can be secured. To meet this emergency the incorporators usually supply the initial funds required, this advance being applied on their subscriptions, or repaid from the corporate funds after organization.

It may be noted that, while as a rule subscriptions to the stock of a new company prior to its organization require formal acceptance by the board of directors, when these latter are elected, to make such subscriptions binding and legally enforceable, the incorporators, by signing the charter application in which their subscriptions appear, make an irrevocable subscription.

When subscriptions are payable on the instalment plan, the terms should be set forth in the subscription agreement. If the company is to issue both common and preferred stock, the subscription agreement should explain the conditions, unless separate blanks are provided for the different kinds of stock.

It might be highly embarrassing to the incorporators to have subscriptions revoked before acceptance by the company; and to avoid this possibility subscriptions may be made through a committee, or a trustee appointed for that purpose, as in the following subscription list. This provides the necessary second party to the contract and makes the subscriptions binding before incorporation. Under such an agreement the new corporation, when organized, may bring suit to enforce payment of the subscription. In a way, however, the agreement is still one-sided, as no contract is binding on the newly organized corporation until accepted

by the corporation itself. This question, however, seldom arises, as the acceptance of subscriptions by the new corporation almost invariably follows.

SUBSCRIPTION LIST

LANCASTER CEMENT COMPANY

To be Incorporated under the Laws of the
State of Pennsylvania for the Manufacture
of Portland Cement

Capital Stock \$1,000,000

Shares \$100 each

We, the undersigned, hereby agree with Thomas G. Williams as Trustee for the Lancaster Cement Company, to subscribe, and do hereby severally subscribe, for the number of shares of the capital stock of said Company set opposite our respective signatures, and agree to pay the par value thereof as follows:

Ten per cent on demand of Thomas G. Williams as Trustee for said Company, such payment, or so much thereof as may be necessary, to be used for the preliminary and incorporating expenses of said Company; thirty per cent to the Treasurer of the Company so soon as said corporation is organized; twenty-five per cent on demand of the Treasurer of the Company at any time after ninety days from the date of incorporation, and the remainder at such times and in such instalments as may be prescribed by the Board of Directors.

Lancaster, Pa.,

May 2, 1916.

Names	Addresses	Shares	Amounts
Ronald Logan	627 Warren Ave., Lancaster	1,000	\$100,000
Samuel Bennett	4425 Spruce St., Philadelphia	1,000	100,000
A. W. Thompson	Lancaster, Pa.	1,000	100,000
J. H. Connor	Harrisburg, Pa.	1,000	100,000
O. K. Ferguson	1420 Arch St., Philadelphia	1,000	100,000

Subscription List, Trustee's

The form illustrated on page 53 is brief and explicit, and is in general use. It may be conveniently inclosed with a prospectus or letter. It reserves to the incorporators

the right to reject or prorate subscriptions, thus enabling them to exclude undesirable subscribers, and to reject or prorate applications in case of over-subscription. It will be seen, in this form, that the names of the incorporators are brought in, but solely as a means of identifying more clearly the proposed corporation. If there is any danger of subscriptions being cancelled, trustees should be made parties to the agreement.

THE RUBBEROID TIRE COMPANY

479 SPRINGFIELD AVENUE
JERSEY CITY, N. J.

To be Incorporated under the Laws of New Jersey for the
Manufacture of Automobile Tires

By Frank Alston, John Stone, and Howard Cole

Capital Stock \$500,000

Shares \$10 each

I hereby subscribe for shares of the capital stock of The Rubberoid Tire Company at the par value thereof, and agree to pay twenty-five per cent of such subscription on demand of the Treasurer so soon as said Company is incorporated, and twenty-five per cent on demand of the Treasurer of the Company at any time after ninety days from the incorporation of said Company; the remainder of said subscription to be paid at such times and in such amounts, not exceeding ten per cent of said subscriptions in any one month, as may be required by the Board of Directors of said Company.

Dated.....

.....
The right is reserved to reject or prorate any or all subscriptions.

Subscription Blank, Individual

§ 56. Instalment Receipts

When subscriptions are payable in instalments, stock certificates should not be issued until the full amount has been paid—a rule that is frequently violated. In some corporations special certificates closely resembling stock scrip are issued upon payment of a prescribed fractional part of the subscription, the certificate itself specifying the terms

of payment and providing space on the back thereof for the indorsement of future instalments. An examination of such a certificate and its indorsements will at any time indicate whether or not the stock is fully paid.

Another method of evidencing payments for stock sold on the instalment plan is to give the subscriber a receipt for each instalment paid. Such receipts are known as "instalment receipts," or "instalment scrip." When the final instalment is paid, the receipts are returned to the company, and a stock certificate is issued for the total number of shares. The stockholder's account in the stockholders ledger will at any time show the status of his account and the amount of his stock holdings.

No. 1

15 Shares

DENTON MANUFACTURING CORPORATION

TRUSTEE'S CERTIFICATE

\$150.00

I hereby certify that Robert H. Craig, a subscriber for Fifteen Shares of the Capital Stock of the Denton Manufacturing Corporation, at its par value of One Hundred Dollars per share, has paid to me as Trustee for said Corporation, on account of said subscription and in accordance with its terms, the sum of One Hundred and Fifty Dollars.

This receipt will, upon the organization of the said Denton Manufacturing Corporation, be received and credited by the Treasurer thereof to its full amount as a payment upon said subscription.

New York,

ELDRIDGE LEWIS,

April 15, 1916

Trustee

Trustee's Receipt for Instalment Payment

The instalment receipt book may consist of an ordinary receipt book from which the receipts are issued, though in large companies special books are usually printed to meet the requirements. The details of each receipt issued are recorded on its stub, from which the proper entries may be obtained for the stockholders ledger and also for the other

books. The receipt is usually signed by the treasurer and perhaps by one other officer of the corporation. If it is desired to sell or transfer the instalment receipt at any time an assignment may be written on the back; or to meet such requirements a form of assignment is sometimes printed on the back of the receipt.

Subscription payments before incorporation are made to a designated trustee or bank, by whom receipts are given for these payments. After incorporation they are made to the treasurer of the company.

TREASURER'S RECEIPT

No. 5

\$100

5 Shares

THE HUDSON RADIATOR COMPANY

30 BROAD STREET

NEW YORK

Received of Edward H. Williamson the sum of One Hundred Dollars, instalment payment No. 5, of Twenty Per Cent upon his subscription for Five Shares of the Capital Stock of the Hudson Radiator Company.

New York City,
March 14, 1916

J. H. WILCOX,
Treasurer

Treasurer's Receipt for Instalment Payment

§ 57. Stock Scrip

Stock scrip, or instalment scrip, is practically a receipt for instalments on account of stock subscriptions; but the one instrument is so arranged as to evidence all the payments made. Stock scrip is usually prepared in more elaborate style than the ordinary instalment receipt, and in such form as to permit of its ready sale and transfer in the same manner as a stock certificate. It is signed by the president and treasurer, and may even bear the seal of the corporation. Subsequent instalments are indorsed on the back so that the scrip will exhibit at any time the payments made upon the holder's subscription.

No. 1 Shares, 15 Payment: \$850 Name, Harold Thompson Date, April 14, 1916.	No. 1 \$850 15 Shares INSTALMENT CERTIFICATE LANSFORD MANUFACTURING CORPORATION 156 Liberty Street New York THIS IS TO CERTIFY that Harold Thompson, a subscriber for Fifteen Shares of the capital stock of the Lansford Manufacturing Corporation of New York City, at its par value of One Hundred Dollars per share, has this day paid into the treasury of the Corporation on account of said subscription and in accordance with its terms, the sum of Eight Hundred and Fifty Dollars. Upon payment of the remaining instalments of said subscription in accordance with the terms thereof, and surrender of this certificate, duly executed certificates for said Fifteen Shares of stock will be issued to the order of the said subscriber. Witness our official signatures this 14th day of April, 1916. WILLIAM H. HANSFORD, <i>Treasurer</i> HARRISON H. GORDON, <i>President</i>
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Stock Scrip—Instalment Payments

Date	Number of Instalment	Amount Paid	Signature of Treasurer
May 3, 1916	2	\$500.00	William H. Hansford
June 2, 1916	3	150.00	William H. Hansford

Instalment Form for Stock Scrip

Instalment scrip, or receipts, may as a rule be sold or assigned at any time before they are called in for cancellation upon final payment. A general form of assignment is:

FOR VALUE RECEIVED, I hereby sell, assign, and transfer unto John H. Wardell of New York City, my subscription to Fifteen Shares of the capital stock of the Lansford Manufacturing Corporation, together with the payments made thereon, all as evidenced by the within certificate, and I do hereby authorize and instruct the proper officials of said Corporation, upon completion of the conditions of my said subscription, to issue said stock to the order of my said assignee.

New York, December 4, 1916

In the presence of

HAROLD THOMPSON

SAMUEL H. KENNARD

Assignment of Subscription and Instalments

§ 58. The Instalment Book

The instalment book is used when an instalment falls due, or when a call or assessment is decided upon by the board of directors. As will be seen by reference to the form which follows, it contains a list of the subscribers, the number of shares subscribed by each, and the amount of the instalment due, together with other information relating to the particular instalment. A new page or sheet is made out for each call or instalment. Instead of rewriting the names for each of these, the same list may be utilized by ruling up the page with groups of columns, each group adapted for one instalment; or by the use of short pages after the first. This arrangement may cause some little inconvenience in case subscription rights and instalments are transferred, thereby necessitating changes of names.

The first column of the instalment book indicates the folio of the stockholders ledger, in which the subscribers' accounts are recorded, payments being posted from the instalment book to the credit of the respective accounts. The last column preceding the remarks column indicates the cash book folio to which the payments may be carried in total each day, these payments being credited to "Capital Stock," "Capital Stock Subscribed," or "Subscribers," according to the plan of opening entries used. Since instalments on subscriptions are not necessarily paid on their due date, it is advisable to carry the total of each day's receipts to the cash book, instead of waiting until all are paid. It is obvious that an account for "Subscribers" must be opened in the general ledger and charged with the aggregate amount of subscriptions due at that particular date. The same procedure is required for each succeeding instalment.

Occasionally, accounts are opened in the general ledger for individual subscribers, debiting them for their subscriptions and crediting them for their payments. If there are many subscribers, this plan is objectionable as encumbering the general ledger with a large number of stockholders' accounts which should by right be contained only in a stockholders ledger (§§ 65, 66).

The instalment book is compiled from the various subscription sheets or individual subscription blanks, and may be either a bound or loose-leaf book. Loose sheets serve the purpose nicely, since they can afterward be bound together for filing.

When subscribers to stock are few in number, the instalment book may be dispensed with; and cash received on instalments may be entered directly in the cash book, and thence posted to the respective subscribers' accounts in the stockholders ledger and in total to the proper account in the general ledger.

CHAPTER V

THE BOOKS AND RECORDS OF A CORPORATION—(Continued)

§ 59. Treasurer's Receipt for Subscription Payment

When a subscription to stock is paid in full, it is customary to issue the subscriber a stock certificate. If the certificates are not ready for delivery, a receipt is given or a temporary certificate is issued. In any such case, the receipt or certificate must be turned in for cancellation before it is replaced with a permanent certificate. The following form of receipt is self-explanatory. It is ordinarily provided with a stub on which the details of the transactions are recorded.

TREASURER'S RECEIPT	No. 50	\$1,000	10 Shares
	WALTON PUBLISHING COMPANY		
	No. 225 ATLANTIC AVENUE		
	BROOKLYN, N. Y.		
	THIS IS TO CERTIFY that Harry H. Wilson has paid into the treasury of the Walton Publishing Company the sum of One Thousand Dollars, payment in full of his subscription for Ten Shares of its capital stock, duly executed certificates for which will, upon surrender of this receipt, be issued to his order as soon as said Certificates are ready for delivery.		
	June 14, 1916	FRANK J. ARDWALD,	<i>Treasurer</i>

Treasurer's Receipt for Stock—Full Payment

§ 60. Stock Certificate Book

There is usually no legal requirement as to the size form, or even the wording of a stock certificate, but it must

show the corporate name, the state in which the corporation is organized, the capitalization, the total number of shares, the number of shares represented by the certificate, and whether such stock is full-paid. The certificates are numbered and issued consecutively. Occasionally, ownership in a corporation will be evidenced by a simple certificate written on the typewriter or with pen and ink; and sometimes, where the ownership is vested in a few persons, no certificates are issued, the stock books of the corporation forming the sole evidence of stock ownership. There is no legal objection to either of these plans, but they are obviously inconvenient and, for the more active corporations, inadequate. Their economy is their chief recommendation.

Separate certificates for the different classes of stock—common stock and preferred stock (as shown on pages 62, 63)—are usually prepared, though it is not unusual for a small corporation to use the same general form of certificate for both. In this case, the word “Preferred” should be printed or stamped across the face of the preferred stock certificate. Such a certificate is imperfect, however, as the conditions under which preferred stock is issued should appear on the face of the certificate.

Stock certificates are usually prepared in books of from 100 to 500 certificates, with a stub for each certificate. Large corporations whose stockholders run up into the thousands must, of course, use a number of these stock certificate books. Separate books for common and preferred stock are generally used, though in small companies both forms of certificates might be bound up in the one book.

In case of transfer of stock, a new certificate should not be issued until the old certificate has been assigned and returned for cancellation. It is customary to paste the cancelled certificate to its original stub.

Certificate No. 38 For 20 shares. Issued to Ralph Johnson, 1736 Pacific Avenue, Camden, N. J. Dated April 10, 1916. From Whom Transferred, Original issue. Dated April 10, 1916.	No. 38 INCORPORATED UNDER THE LAWS OF THE STATE OF NEW JERSEY THE VENTNOR STOVE COMPANY Capital Stock..... \$150,000 Common Stock \$100,000 Preferred Stock \$50,000 Full-Paid and Non-Assessable THIS IS TO CERTIFY, that Ralph Johnson is the owner of Twenty Shares of the capital stock of The Ventnor Stove Company, transferable only on the books of the Company by the said owner thereof, in person or by duly authorized attorney, upon surrender of this certificate properly indorsed. Witness the Seal of the Company and the signatures of its duly authorized officers this tenth day of April, 1916. { CORPORATE } { SEAL } W. H. WILKINSON, <i>Treasurer</i> ANDREW W. SIMPSON, <i>President</i> Shares, \$100 each	20 Shares
Received Certificate No. 38 for Twenty Shares this 12th day of April, 1916. Ralph Johnson		

Stock Certificate, Common

No. 15

INCORPORATED UNDER THE LAWS OF
THE STATE OF NEW JERSEY

10 Shares

THE VENTNOR STOVE COMPANY

Capital Stock.....	\$150,000
Common Stock \$100,000	Preferred Stock \$50,000
Full-Paid and Non-Assessable	

THIS IS TO CERTIFY, that George Bower is the owner of Ten Shares of the Preferred Stock of The Ventnor Stove Company, transferable only on the books of the Company by the said owner, in person or by duly authorized attorney, upon surrender of this certificate properly indorsed.

The holder of the preferred stock represented by this certificate is entitled to an annual dividend of Six Per Cent (6%), payable out of the net profits of the Company before any dividend is paid upon the common stock. Should the net profits in any year be insufficient to pay said preferred dividend, either in whole or in part, any unpaid portion thereof shall become a charge against the net profits of the Company, and shall be paid in full out of said net profits before any dividends are paid upon the common stock.

In event of the dissolution of the corporation from any cause, holders of preferred stock shall be paid from the assets to the par value of their stock and all arrearages of dividends before anything is paid to the holders of common stock.

Said preferred stock is subject to redemption at the option of the Company at any time after Ten (10) Years from the first day of August, 1916, upon payment of One Hundred and Five Dollars (\$105) per share and any accumulated dividends.

Said preferred stock is not entitled to vote at stockholders' meetings of the Company, nor to participate in profits beyond its fixed, preferential, cumulative, annual dividend of Six Per Cent.

{ CORPORATE } Witness the Seal of the Company and the signatures
 SEAL of its duly authorized officers this second day of
 April, 1916.

W. H. WILKINSON,
Treasurer

ANDREW W. SIMPSON,
President

Shares, \$100 each

Stock Certificate, Preferred—(Stub omitted)

§ 61. Assignment of Stock Certificate

When stock is to be transferred, the form of assignment which appears on the back of the certificate is signed by the transferor. It is then witnessed, and the certificate is usually handed to the new owner with the remaining blanks of the assignment unfilled. This is called an "assignment in blank," and the equitable title to the stock then vests in the holder of the certificate, as the name of an assignee is not filled in. But since no transfer has been made on the books of the corporation, the legal title remains in the former owner, who is still the owner of record, i.e., the owner as shown by the books of the corporation, and is therefore technically entitled to exercise all the rights of ownership.

FOR VALUE RECEIVED, I hereby sell, assign and transfer unto
 of
 shares of the capital stock represented by the
 within certificate, and do hereby irrevocably constitute and appoint
 my Attorney to transfer the said
 stock on the books of the within-named Company, with full power of
 substitution in the premises.

JOSEPH A. LONGSTREET

Dated.....19....

In presence of

.....

Assignment of Stock Certificate

As long as the assignment on the certificate is left blank, the certificate may be passed from hand to hand without further formality as to assignment, and carries with it the equitable title to the stock it represents. Whenever the owner of the assigned certificate wishes to have the stock transferred to himself on the books of the corporation, i.e., put in his own name, he surrenders the certificate to the proper officer of the corporation—usually the secretary—

with instructions as to reissue of the stock. He may, if he wishes, fill in the blanks in the assignment on the back of the certificate before surrendering it, but, if not, the blanks are filled in by the officer of the corporation, usually with his own name, and the attorney thus named in the assignment signs the transfer book—if one is kept. After the transfer has been recorded, a new certificate is issued to the new owner of record in accordance with his instructions.

Frequently the holder of a certificate for a number of shares desires to transfer part of them, in which case his certificate is cancelled, a new one is made out to him for the number of shares still remaining to his credit, and a new certificate is also made out in favor of the transferee for the number of shares transferred. Sometimes, on the other hand, a stockholder desires to surrender a certificate and take in exchange two or more certificates, each for a smaller number of shares. This is called a "split." Or, sometimes several certificates of smaller amounts are surrendered in exchange for a single certificate. This also is known as a "split."

In any of these cases, the certificates must be assigned as required by the conditions, and the proper records must be made in the transfer book, in the transfer register, and in the stock certificate book; the cancelled certificates being pasted back on their own stubs at the time the new issue is made. In such cases, the stock assignment and the transfer book state that the new stock certificates are to be made out "to myself," or "to myself.....shares, and to shares," as the case may be

Stock brokers often have continuing powers of attorney from those for whom they act, to transfer the stocks which come into the possession of these brokers in the course of business. On the other hand, large corporations generally appoint a special transfer agent or registrar, or both, to

look after the transfer and issue of stock certificates. A trust company is usually appointed to perform such duties. In such case the trust company countersigns all certificates issued, and supervises all other matters pertaining to the company's stock.

§ 62. Stock Transfer Book

The transfer book both authorizes and records the transfers of shares of stock of the corporation. It is, as to its wording, practically a duplication of the assignment ordinarily appearing on the back of every stock certificate. By many corporations the stock transfer book is not kept at all, since the duly executed assignment on the back of the certificate is regarded as sufficient authorization for the transfer of the assigned stock.

The form of transfer book is usually about as follows :

Ledger Folio 29

Transfer No. 326

GOODWIN AUTO CAR COMPANY

For Value Received, I hereby sell, assign, and transfer unto James W. Strong of Trenton, New Jersey, Fifty Shares of the Capital Stock of the above-named Company, now standing in my name on the Company books and represented by surrendered Certificates Nos. 32, 37, and 44.

Witness my hand and seal this 20th day of March, 1916.

THOMAS L. BORDEN [L.S.]

By HENRY STRONG,

Attorney

New Certificate No. 196

Issued to James W. Strong

Ledger Folio No. 72

Stock Transfer Book

This form remains in the book and is evidence of authority of transfer. A record of all transfers is thus secured in one book, from which postings can be made and to which reference may be had at any time. The book

usually contains from two to six transfer forms on each page, one below the other. Transfer books are frequently prepared with stubs, but these stubs are not necessary and may be left blank, as the transfers are not torn out.

It is usual to close the transfer books a certain number of days before the annual meeting and before dividend days; and during these periods stock cannot be transferred on the corporate records. This "closing of the transfer books" merely amounts to a refusal of the officials in charge of the stock books to register transfers of stock for the stated number of days before the annual meeting or before the day appointed for the payment of dividends. The registered holder on the date when the transfer books are closed is therefore the person who is technically entitled to vote at the next stockholders' meeting or to participate in the dividends, even though he may have sold his stock meanwhile. In any such case, the purchaser must look to the seller for any voting and dividend rights to which he is entitled because of the stock he purchased. (See § 36.)

§ 63. Register of Transfers

Sometimes another book—the register of transfers—is used in addition to the transfer record mentioned above. In such case this book serves as a convenient medium through which postings are made to the stock ledger. It is apparent, of course, that for every stock certificate transferred, a debit must be made to the transferor and a credit to the transferee.

A transfer register is required only in a large corporation where many transfers are being made. In a small company where the stock is inactive, it is not necessary; and postings may then be made from the transfer book or even from the stock certificate book. The following is a simple form of transfer register :

When a trust company acts as transfer agent, it is customary, as already stated, to have all certificates countersigned by the transfer agent after they have been signed by the president and treasurer of the corporation which issues the stock. The form of countersignature is about as follows:

Countersigned this 21st day of May, 1916.

ACME TRUST COMPANY OF NEW YORK,

Transfer Agent

By JOSEPH H. WILSON,

Auditor

§ 64. Stock Register

This book is used, in addition to the stock transfer book, for the registration of stock in cases where a registrar of stock is deemed necessary. The registrar is generally a bank or trust company. By having the issue of all stock supervised by the registrar, provision is made against irregular issues or overissues of certificates. The number of shares legally authorized to be issued is recorded on this register and should exactly equal the number of outstanding shares, plus any authorized shares not yet actually issued by the corporation.

The rules of the New York Stock Exchange require every company whose shares are dealt in on the Exchange to have an independent registrar approved by the Exchange.

Each new certificate issued, whether original or transfer, must be countersigned by the registrar, about as follows:

Registered this day of 191..

BUSINESS TRUST COMPANY, *Registrar*

By.....

§ 65. Stock Book or Stock Ledger

Some form of stock book, stock ledger, or share ledger—which are practically one and the same—must, in most states, be kept as a matter of statutory requirement. The stock ledger is primarily intended to show the stock acquired, any transferred, and the number of shares held at the time by each stockholder; but it is sometimes also used as a stockholders ledger to show payments made on account of subscriptions. This record is better kept in a separate stockholders ledger. It is obvious that the great majority of the stock ledger entries are transfers of stock in which the corporation has no financial interest; and the financial side of the comparatively few original entries in which it is interested should not be brought into this book.

The stock ledger is the proper legal evidence (§§ 14, 15) of the ownership of stock in a corporation. A stock certificate may be lost or destroyed, or may, in case of fraud or error, appear under a different name, but the stock book still assures to the “stockholder of record” his corporate rights and privileges. Stockholders have the right to inspect the stock book at reasonable times and to take extracts therefrom if desired—a privilege which is manifestly liable to abuse if not properly restricted.

The stock ledger records the name and address of each stockholder, the number of shares issued to him, any shares subsequently acquired, any shares transferred, and the balance of shares remaining to his credit. It also shows the numbers of the certificates issued to the individual, the numbers transferred, and the date of each transaction. Postings to the stock ledger are made from the subscription lists or blanks, or, in the absence of these in the case of original issues, from the stock certificate book. Transfers of stock are posted from the transfer book, transfer register, or stock certificate book, to the proper accounts in the stock ledger.

Preferred stock should be recorded in a separate stock book, or in its own section of the stock ledger; for it is obvious that the attempt to keep a record of both kinds of stock in one account would lead to confusion.

A capital stock account is sometimes opened on the front page of the stock ledger, and debited with the aggregate amount of shares credited to the stockholders' accounts. This provides a double entry for the stock ledger, and enables the secretary to tell at any time the amount of stock outstanding. The stock ledger must, of course, agree as to totals with the capital stock account in the general ledger; or, if the stock is not all issued, with the capital stock account less all unissued stock.

§ 66. Form of Stock Book or Stock Ledger

There is no generally accepted form of stock book, or stock ledger, save in some few states (as New York) where its form is prescribed by law. In most of the states, therefore, the secretary, or the accountant who has charge of the corporate accounting system, must decide its form and the method of entry. As a matter of fact, the accountant usually uses the form available at the stationery store or supply house with which he deals.

It must always be kept in mind that the great object of the stock book is to show at any time the number of shares then standing in the stockholder's name—not the amounts paid on these shares, nor their par value, but the number of shares. In practice there are two methods of keeping this record. In some forms the stockholders' accounts are debited for stock purchased, and credited for stock sold; while in others the stockholders' accounts are credited when stock is purchased, and debited when it is sold. As the book is not part of the general accounting system, this variation is not a matter of importance so long as the details

are correctly recorded and full information obtainable. The important point is for the record to show at a glance the balance of stock owned by each stockholder.

In many cases the stockholders' accounts are ruled in the regular ledger form (as shown in the following form), which serves the purpose very well so long as the stock is fully paid and but few transfers are made. It is apparent, however, that in large companies, where transfers are numerous and the accounts of stockholders are constantly changing, a more complete record is desirable and even essential.

RALPH MOORE, 1439 Chestnut Street

1916				1916			
May	4	To John Kane, 20 shares....	\$2,000 00	May	1	50 shares, orig- inal	\$5,000 00
"	4	Balance, 70 shares	7,000 00	"	2	40 shares, orig- inal	4,000 00
			\$9,000 00				\$9,000 00
				May	4	Balance, 70 shares	\$7,000 00

Stock Ledger Account

The stock book may be either bound, loose-leaf, or in card form. The forms of stock book which follow are in general use.

The form shown may be readily changed to meet any special requirements. The leaves of the stock book are indexed, usually as a matter of convenience, but in some states to secure the alphabetical arrangement required by statute. The name and address of the stockholder with whom the particular account is kept appears at the head of the page as in an ordinary ledger. On the right-hand side of the page the party is credited with the stock he purchases or otherwise acquires; and on the left-hand side he is debited

with any stock disposed of. The difference between the two sides shows at any time the amount of stock standing to his credit.

Where a number of certificates are issued or cancelled in a single transaction, the entry will vary according to the conditions. If but a few certificate numbers are involved, they may usually be entered in small figures on the line in the proper column. If the numbers are too many to be entered in this way, two or more lines may be devoted to the transaction; or the numbers may be noted at the bottom of the page, reference to these numbers being inserted in the column where the numbers ordinarily appear. However, if the certificates cancelled or issued are in different names, one line must necessarily be given for each certificate.

In New York a special form of stock book has been prescribed by the State Comptroller, acting under authority given him by law. The use of this form by New York corporations is obligatory. The forms on page 75 show, respectively, stock book prescribed for the use of brokers, and the stock book for corporations and transfer agents. The only new feature in these prescribed forms is the introduction of the special columns for the record of the stamp tax paid on transfers.

§ 67. Dividend Book

This book, used only when dividends are declared, contains a list of the stockholders who are entitled to participate in these dividends. It may be a bound book or simply loose sheets fastened together in a binder. After the stock books are closed for dividends, the registered holders of stock are recorded in this book in alphabetical order with all the necessary data against each name.

Most corporations pay dividends by check, and many of them open special bank accounts for dividend purposes.

In this case, the total amount of the dividend to be paid out is deposited, and specially printed checks are drawn against it in favor of the stockholders for the dividends due. Since these checks specify the number and date of the dividend as well as the amount, they serve as vouchers and do not require an acknowledgment. A convenient form of dividend book is shown on page 77. A form of dividend check and of the notice usually accompanying it are as follows:

PREFERRED STOCK DIVIDEND

No. 10

GREAT WESTERN MILLING COMPANY

Portland, Oregon, June 5, 1916

No. 2438

FIRST NATIONAL BANK
of Portland, Oregon

Pay to the order of

James D. Moore..... \$150.00
One Hundred and Fifty 00/100.....Dollars

Countersigned:

STOCK TRANSFER DEPARTMENT,
JOHN FISKE, *Transfer Agent*GEORGE H. SEYMOUR,
*Treasurer**Dividend Check*

GREAT WESTERN MILLING COMPANY

Portland, Oregon

June 5, 1916

On May 6, 1916, the Directors declared quarterly dividend No. 10 of One and One-half Per Cent upon the Preferred Stock of the Company, payable this day to stockholders of record of May 16, 1916.

In accordance with permanent order on file, enclosed please find check for above dividend on the Preferred Stock standing in your name. No acknowledgment is necessary.

Kindly advise Charles E. Howe, Assistant Treasurer, 282 Washington Street, Portland, Oregon, of any change in your address, giving your old address as well as the new.

GEORGE H. SEYMOUR,
Treasurer

Dividend check enclosed which please cash immediately.

Notice Accompanying Dividend Check

§ 68. Dividend Order

The larger corporations usually require their stockholders to file orders giving definite instructions as to the payment of dividends. In most cases, dividends go to the stockholder of record, but a stockholder sometimes desires all or a part of the dividends upon his shares to be paid to some other person, or to a bank or trust company. A simple form of permanent dividend order frequently used is as follows:

PERMANENT DIVIDEND ORDER Please give full name and post-office address to which check is to be mailed.	(DATE HERE).....191..
	TREASURER.....
	
	Until this order is revoked in writing, please remit by mail, to the address as per margin, by check drawn to order of.....
	
	all dividends now due, or which may hereafter be declared, on shares of the Capital Stock of your Company now or hereafter standing in the name of
	WITNESS :
	(Give name exactly as it appears on stock certificate)
	
	(Shareholder sign here)

When the check is to be made payable to another person, have signature acknowledged before a notary public.

CHAPTER VI

DISTINCTIVE CORPORATE ACCOUNTS

§ 69. Accounts Peculiar to Corporate Bookkeeping

As has been stated, there are certain accounts peculiar to corporation accounting, or so rarely used outside of it, as to be distinctive. In the present chapter an analysis of the more important of these accounts is given in ledger form, with respective debits and credits appearing upon the proper side of each account. The journal entries through which the component parts of these accounts are brought upon the books are more fully discussed in following chapters.

It should be noted that there is some diversity of opinion as to the accounts and entries that are best employed under the varying conditions that confront the corporation accountant. In any case, however, that plan seems best which will provide all of the information desired with the fewest possible repetitions. The present chapter is designed to cover all the accounts used in ordinary corporation accounting.

§ 70. Capital Stock—Common

Debit:

With the par value of any common shares retired.

Credit:

With the par value of common shares issued; or

With the entire authorized value in case an Unissued Stock account is opened.

When no preferred stock is issued—in which case but

one kind of stock is issued—the foregoing account will be known simply as “Capital Stock,” to which the above rules will apply without change.

If an Unissued Stock account is not opened, the balance of the Capital Stock account represents the par value of common stock issued and outstanding. The stock ledger (§§ 65, 66) will also show the stock issued and outstanding, though ordinarily in shares and not in value. If the par value of the stock acquired by, and disposed of by the stockholders is also entered in the stock ledger, it may then be operated as a subsidiary record, the Capital Stock account becoming the controlling account.

If an Unissued Stock account is opened, the balance of the Capital Stock account shows the total authorized stock, while the balance of the Unissued Stock account shows the amount still unissued.

The Capital Stock accounts as above constituted show the amount of capital invested in the corporation by the stockholders (who are the real owners), very much as the Capital account of a partnership or sole proprietorship business shows the investment of the partners or proprietor. The accounts represent a nominal liability to creditors and to the stockholders, whose claims in the event of liquidation are considered only after all secured and unsecured creditors are satisfied. (See also Chapter VII, and §§ 144, 166.)

§ 71. Capital Stock—Preferred

Debit:

With the par value of preferred shares retired.

Credit:

With the par value of preferred shares issued; or

With the entire authorized value in case an Unissued Stock account is opened for preferred stock.

The balance of this account represents the par value of preferred stock issued and outstanding, or of the total preferred stock authorized, as the case may be. If the latter, the Unissued Stock—Preferred account will show the amount of preferred stock still unissued.

§ 72. Capital Stock Authorized

<i>Debit:</i>	<i>Credit:</i>
With the par value of shares disposed of, the corresponding credit being made to Capital Stock or to Capital Stock Subscribed.	With the par value of shares authorized, the corresponding debit being made to Unissued Stock.

This account when used shows a credit balance, indicating the par value of stock authorized and not yet disposed of. It is sometimes opened in order to bring onto the books at the time of organization the entire amount of capital stock authorized by charter, regardless of whether or not any portion thereof has been disposed of. A separate account should be opened for each class of stock, the corresponding debit to Unissued Stock account having a like classification.

This is a favorite account with many bookkeepers and accountants, but so long as the Unissued Stock account indicates the amount of stock authorized and unsold, there seems little need of another account to exhibit the same information. The account has some merit, however, especially in affording a means of recording a neutral opening entry in the corporate books, and in exhibiting by ledger accounts the amounts of capital stock both sold and unsold. (See also §§ 97, 154.)

Undoubtedly most accountants credit Capital Stock account at the beginning for either the entire authorized

capital stock or for the amount issued, and in such case the Capital Stock Authorized account would not be required.

§ 73. Unissued Stock*

Debit:

With the par value of shares authorized, the offsetting credit being made to Capital Stock or to Capital Stock Authorized.

Credit:

With the par value of shares subscribed, the offsetting debit being made to Cash, to the proper property account, or to Subscriptions to Stock, as the case may be.

This account, also known as Unsubscribed Stock, shows at any time the par value of shares of a corporation authorized by charter but not yet subscribed and paid for. It shows a debit balance indicating the amount of stock still unissued, and is a negative to Capital Stock account, or to Capital Stock Authorized account in case the latter is opened. It must be borne in mind that instalment subscriptions, until they are fully paid, are carried in Capital Stock Subscribed account when that account is used, and do not show in the Capital Stock account until they are fully paid.

Many accountants prefer to credit Capital Stock with only the par value of shares sold, in which case Unissued Stock account is not needed; and yet the account has a mission and is frequently used. On the balance sheet, however, the unissued stock is preferably deducted from the authorized capital stock of the corporation and is not shown among the assets. (See also Chapter VII, and §§ 144, 166.)

*Separate account for each class of stock unissued.

§ 74. Subscriptions to Stock**Debit:*

With the amount of subscriptions for capital stock. (At this time credit Capital Stock Subscribed, Unissued Stock, Treasury Stock, or Capital Stock account, as the case may be.

Credit:

With all moneys received to cover subscriptions, or with the amount of each instalment due by subscribers when an Instalment account is maintained.

Subscriptions to Stock account shows a debit balance, if any. Other names for this account are "Subscriptions," "Stock Subscriptions," and "Subscribers." The balance is an asset, and—save when an instalment account is opened—represents the amount due and unpaid on subscriptions for capital stock sold on the instalment plan. Debits to this account are offset by credits to Unissued Stock, Capital Stock Subscribed, or Treasury Stock account, as the case may be, or even to Capital Stock account. Sometimes it is opened to show the total amount of stock subscribed, even though payment of part or all of these subscriptions is to be made in full at once or in a short time. Subscriptions to treasury stock should preferably be opened under another heading, such as "Subscriptions to Treasury," to distinguish them from subscriptions to unissued stock.

A subscription ledger should be kept as a subsidiary record to the Subscriptions to Stock account, and an account with each subscriber kept therein. The respective subscribers' accounts should be debited separately with the amounts of the subscriptions, and credited with the amounts of the payments which they make on account of the subscriptions. The results of a trial balance taken from this subsidiary ledger should agree with the balance of the Subscriptions to Stock account. (See also §§ 65, 66, 98-100, 150.)

*Separate account for each class of stock sold.

§ 75. Capital Stock Subscribed*

Debit:

With the par value of subscriptions which have been fully paid; at which time certificates of stock should be issued, covering the number of shares subscribed and paid for. (At this time credit Capital Stock, Unissued Stock, or Treasury Stock, as the case may be.)

Credit:

With the par value of capital stock sold on the instalment or deferred payment plan. (At this time debit Subscriptions to Stock account.)

Sometimes subscriptions to stock—especially when on the instalment plan—fail after they are made. Stock certificates should not be issued to subscribers until their respective subscriptions have been paid in full. Capital Stock Subscribed account is therefore opened as a suspense account in which subscriptions may be carried until they are paid in full.

The balance of Capital Stock Subscribed account is a nominal liability, and represents the par value of each subscription until this subscription has been fully paid—not the amount due on these subscriptions, which is shown by Subscriptions to Stock account, but the total original par value of all unpaid subscriptions. When subscriptions are paid in full and certificates are issued, the Capital Stock Subscribed account is debited and Capital Stock account or Unissued Stock account, or perhaps Treasury Stock account, is credited. Instead of opening this account, credits for stock subscribed on the instalment plan are frequently made directly to Capital Stock; or it is omitted entirely in case a Capital Stock Authorized account is opened.

The difference between the balance of Subscriptions to Stock account and the balance of this account should agree

*Separate account for each class of stock subscribed.

with the amount of cash received on account of subscriptions not fully paid. It will thus be seen that the balance of this account is an offset to the cash received on account of subscriptions not fully paid, and the remaining part of it is an offset against the balance of the Subscriptions to Stock account. (See also § 97.)

§ 76. Instalment Account

Debit:

With the amount of instalments due by subscribers to shares of stock, the offsetting credit being to Subscriptions to Stock account, or Unissued Stock account.

Credit:

With payments on account of instalment subscriptions.

This account is employed only when a considerable amount of stock has been subscribed—usually at the time the corporation is organized—and payment therefor is to be made in instalments in fixed amounts and at fixed times or on call.

The account is opened afresh each time an instalment falls due. As each instalment is due a credit is made to Subscriptions to Stock and a debit to the particular instalment, as "Instalment No. 1, 25%," "Instalment No. 2, 25%," and so on, as the case may be. It shows a debit balance and remains open only until payments on the particular instalment are made. Sometimes an account for "Subscribers" is opened in its place, and even an account in the name of each individual subscriber when these are not too numerous. The main object is to show the amounts subscribed by individuals, when the instalments are due and how much, and the amounts paid thereon. (See also §§ 98-100, 150, 152.)

§ 77. Treasury Stock*Debit:*

With the cost price of capital stock issued by a corporation and subsequently purchased by it.

With the market value of shares donated to the treasury. If such stock has no positive market value, the transaction may be brought on the books by debiting the account with the par value of the shares donated, Donation account being credited.

Credit:

With the cost, or realized value, as the case may be, when shares debited to this account are disposed of; in other words, with the value at which the shares disposed of were charged to this account. If the price actually realized was more or less than that at which the stock was charged to this account, the difference is credited or debited, as the case may be, to Donation account.

The balance of this account is an asset, and, save in the case of donated stock, should represent the cost of treasury shares owned. (See also Chapter VIII, and §§ 27, 155, 166.) A separate account is sometimes opened for Donated Stock instead of Treasury Stock. This caption is a good one and easily understood.

§ 78. Donation Account*Debit:*

With the discount on donated stock sold below the value at which it was credited to this account, and with any expense in connection with such sale.

With the amount transferred at any time to Profit and Loss or to Surplus, as a result of stock donated.

Credit:

With the market or par value, as the case may be, of corporation stock donated back to the company for resale to provide working funds, the offsetting debit being to Treasury Stock account.

With the excess when donated stock is sold for more than the value at which it was credited to this account.

The balance of this account—also known as Working Capital Donated account—is always on the credit side and is a nominal liability, being an offset to Treasury Stock account. As stock is sold and profit made thereby, such profit, after deducting any expenses connected therewith, may be carried to Profit and Loss or to Surplus, or else be permitted to remain in Donation account until all of the donated stock is disposed of. It may then be closed off as suggested, or be permitted to stand as a credit balance to the account. It is a profit in any case, which should be kept as a permanent reserve and not paid out in dividends. In most cases, however, it eventually finds its way to Surplus account. (See also Chapter VIII, and §§ 27, 155, 166.)

§ 79. Premium on Capital Stock

Debit:

With any transfer from this account by amortization or otherwise, to Profit and Loss, Surplus, or any other account.

Credit:

With the sale price of shares over and above the par value thereof.

The credit balance of this account, sometimes called Capital Surplus, shows the amount of premium not yet written off. It is a profit to the corporation, but not one that should be used for the payment of dividends. The preferable way is to amortize it over a term of five or ten years by yearly or monthly credits to Profit and Loss. It is frequently carried as a permanent credit to Surplus account, especially in banks and other corporations where it is the practice to sell stock at a premium even at the time of organization. (See also §§ 103, 104.)

If stock should be sold at a discount—a dubious proceeding—an account called Stock Discount account may be opened. (See § 102.)

§ 80. Capital Stock Without Par Value

Debit:

With number of shares retired, at the price at which they were credited to this account when sold.

Credit:

With number of shares issued, at the sale price thereof. The corresponding debit is to Cash, to the proper property account, or to Subscriptions to Stock, as the case may be.

With subsequent sales of stock, at the sale price thereof.

This account shows a credit balance and is a nominal liability representing the outstanding capital stock of the corporation, provided there is no other kind of stock issued. There being no par value to the shares of stock, each share represents a fractional part of the net worth (composed of capital and surplus), in proportion to the total number of shares issued. The account is preferably credited with shares at the sale price regardless of prices which preceded; though some advocate crediting the account at one price for all sales of stock, and crediting any amount received in excess thereof to Surplus or Stock Premium account. So long as this is the only class of stock issued, however, it matters little, so far as the book value of the shares is concerned, whether such premium be credited to Capital or to Surplus account; and yet good practice favors the plan outlined above, so that only earned profits are permitted to appear in the Surplus account. In any case, the share value as between the shares would be the same, each being a proportionate part of the net worth.

Certificates of stock without par value simply indicate the undivided interest of the holder in the net worth of the corporation, according to the number of shares held. The balance sheet, in addition to stating the capital and surplus of the concern, should state (either in the body

thereof or as a footnote thereto) the number of shares and perhaps the amount paid in on each of the shares outstanding, thus giving a ready means for determining the sale price and the book value of each unit of interest.

If there be more than one class of stock outstanding, each class has its own status in relation to the entire capital stock. Preferred stock, after receiving its required dividend, may or may not be entitled to a share of any further distribution of profits; likewise, common stock both with and without par value may be issued, so that the status of each must be prescribed in the charter or the by-laws of the corporation.

The following balance sheet indicates the distinction between 7% cumulative preferred stock and common stock without par value.

BALANCE SHEET

CONDENSED BALANCE SHEET OF THE AETNA EXPLOSIVES CO., INC.,
AND SUBSIDIARY COMPANIES AS OF MARCH 31, 1916

<i>Assets</i>		<i>Liabilities</i>	
Commercial Plants and Properties	\$2,970,522	Common Stock, no par value; on which has been paid in in assets*	\$12,578,580
Munition Plants and Properties	12,732,568	Preferred Stock, par \$100	5,495,900
Good-Will	3,391,476	Capital Stock of Subsidiary Companies Not Held by Aetna Explosives Co., Inc..	380,667
Securities Owned (book values)	143,436	Funded Debt.....	2,228,500
Inventory, Notes, and Accounts Receivable and Cash.....	9,467,627	Current Liabilities.....	5,386,824
Special Deposits in Escrow and on Contract Advances	3,395,183	Reserves and Advances on Contracts.....	5,836,200
Deferred Charges.....	344,891	Surplus	539,031
Total.....	<u>\$32,445,702</u>	Total.....	<u>\$32,445,702</u>

*630,000 shares outstanding.

It is advocated by some that when stock is issued without par value and there is only one class of stock, all outstanding, there is no necessity for making a division between Capital Stock and Surplus accounts, since the net profits each time, either before or after paying dividends, may be credited to the Capital account or to Net Worth, as the case may be. Whatever the name, the account selected under this plan bears the credit of capital paid in and is credited with the accumulation of profits, and debited with the distribution of dividends. In that case, the capital account would change from year to year, or each time the books are closed, like the capital of a partnership. The net amount credited to Capital, divided by the total number of shares outstanding, would give the book value per share. It is preferable, however, in any case, to keep capital contributions and surplus profits in separate accounts. In case the company issued both stock bearing a par value and stock without par value, care must be taken to show the portion of the profits belonging to each, though this division may or may not be made on the balance sheet.

Impairment of capital by payment of excessive dividends must be carefully guarded against in a company where the stock has no par value. To prevent this, the amount per share paid in on the stock should be stated in the balance sheet and also in the ledger account itself, and profits be kept entirely separated from the capital paid in to the company.

Non-stock corporations, as clubs, societies, hospitals, and other eleemosynary institutions, require a similar treatment as to capital contributed and profits earned. In these particular cases, however, as no stock is issued and no profits are distributed, there is usually no individual interest to be determined. Everything contributed is for the benefit of the institution as such, and should therefore be credited

to Capital account. Any profits earned are likewise credited to Capital account unless it is required that profits be set forth separately, while appropriations for any specific purpose are charged to the same account. There is no objection, however, to crediting profits to a separate account, such as Surplus or Unappropriated Profits, and then making transfers therefrom as needed either to increase the Capital account or to be used in other ways. (See § 22.)

§ 81. Organization Expenses

Debit:

With the cost of all organization expenses, such as attorney's and accountant's fees, incorporating expenses, promoters' services, underwriting expenses, etc.

Credit:

At the close of each month or fiscal period, as the case may be (depending on whether profits are ascertained monthly or only as often as a physical inventory is made), with the proper proportion of the debits to this account, based upon the number of years over which the organization expenses are to be spread.

The balance of this account is a deferred asset, and represents the proportion of organization expenses which are to be charged off over a given number of years to Profit and Loss.

When the expenses of organization amounts to more than, say, \$500, it is hardly just to charge the entire amount to Profit and Loss at any one time. Such expenses are absolutely essential to the creation of the business, and the first year receives no more benefit from the expenditure than the fifth or sixth. It would therefore seem more equitable, so far as the statistical feature of bookkeeping is concerned, to write such expenses off over such a period of years as the management may elect. Probably five years

would be sufficient for this purpose, in which case one-fifth of the total amount should be charged off each year. (See also §§ 154, 166.)

§ 82. Surplus

Debit:

With the amount of dividends declared (in case such amount is not charged to Profit and Loss).

With amounts reserved for sinking fund or other similar purposes (in case such amount is not charged to Profit and Loss).

With any adjustment during the fiscal period which diminishes the profits of a previous fiscal period.

At the close of each fiscal period, with the net loss, if any, as shown by the Profit and Loss account.

Credit:

At the close of each fiscal period, with the net profit, if any, as shown by the Profit and Loss account.

With any adjustments made during a fiscal period which should have been credited to some profit and loss account within a prior fiscal period; or which increase the profits of a prior fiscal period.

The balance of this account at the close of a fiscal period represents the undivided profits. It should equal the difference between the assets and liabilities, less the balance of the capital account, or accounts, as the case may be (i.e., Capital Stock, Profit and Loss, etc.). Surplus is an increment of capital. When added to the balance of the capital account (or accounts), the sum total should represent the net worth of the business. Surplus account may even show a debit balance as a result of business depression, heavy losses, or payment of excessive dividends. In that case, such deficit represents a loss and the capital impairment of the company.

Surplus account should represent the accumulation of undivided profits. It may include items other than realized profits, or it may be diminished by writing down assets below their real value. When this is done, the process is called "creating a secret reserve." When the credit side of the Surplus account is increased by figures which do not represent realized profits, the act is called "creating fictitious assets," or "watering the assets." It may also be credited with the amount paid for shares of stock in excess of the par value—a practice that is followed by many new corporations such as banks and insurance companies.

When an asset account is arbitrarily increased by a book entry, the credit usually finds its way to Surplus. When a business wishes to falsify the amount of its surplus, it usually does so by inflating some fixed asset account. Consequently, a report of an auditor is of no value unless he analyzes all debits and credits to the Surplus account from the beginning of business, and is willing to certify, without qualification, to the correctness of the balance of the Surplus account at the time his audit is made. (See also Chapter XXIII.)

§ 83. Dividends

Debit:

With dividends paid, whether by cash or by an issue of stock or otherwise.

Credit:

With the amount of dividends declared by the board of directors, the corresponding debit being made to Surplus account or to Undivided Profits account.

The balance of this account represents dividends declared but not paid. It is advisable, when crediting this account, to number consecutively the dividends declared, as "Dividend No. 20," or "Dividend No. 20, payable August 1,

1916." A new account need not be opened each time a dividend is declared, though this is frequently done. (See also Chapters IX, X.)

§ 84. Bonds

Debit:

With the par value of bonds retired.

Credit:

With the par value of bonds issued or assumed; or

With the par value of bonds authorized for issue in case a corresponding account is opened for bonds not issued.

The balance of this account represents the par value of bonds outstanding, and is a fixed liability.

Unissued bonds need not be shown on the books, though there is no serious objection to doing so. It is well, however, to show as a parenthetical note at the top of the Bonds account, the amount of the authorized issue. Accounts are opened for different kinds of bonds, and the tenor of the same clearly set forth in the title of these accounts, as "First Mortgage 5% Bonds of 1940," "Collateral Trust 5% Bonds," "First Mortgage Thirty-Year Sinking Fund Gold Bonds," etc. (See also Chapter XVII.)

§ 85. Bond Premium

Debit:

With proportionate amounts written off monthly or yearly to Profit and Loss.

Credit:

With premium received on bonds sold above par.

This account when it exists has a credit balance and shows the amount of bond premium not yet written off. It is a profit to the corporation but not one that should be used

for the payment of dividends. The preferable way is to amortize it over a term of five or ten years by yearly or monthly credits to Profit and Loss. It might even be credited to Bond Discount account in case such an account exists on the books, especially in the case of industrial corporations not controlled by commission regulations. On the balance sheet the bond premium is usually carried among the deferred credit items on the liability side (See also Chapter XIX.)

§ 86. Bond Discount

Debit:

With the discount allowed to bankers or underwriters on sale of the company's bonds.

With other bond issue expenses incurred at the date of issue.

Credit:

With proportionate amounts written off either monthly or yearly to Profit and Loss account.

This account is a nominal deferred asset which is usually spread over a term of years, but, if the profits will justify it, may be all charged off during the first one or two years. It is the practice to charge all expenses incident to a bond issue to some account known as "Discount on Bonds," or "Bond Discount and Expense," and then to amortize the amount of this expense over a term of years or over the life of the bonds by yearly or monthly charges to Profit and Loss. (See also Chapter XIX, "Bond Discount and Premium.")

Bond discount and underwriting expenses are common to nearly all corporate bond issues, and, while it is permissible to wipe such charge off during the life of the bonds, frequently a shorter period is taken as a basis of apportionment.

§ 87. Interest on Bonds*Debit:*

At the close of each month, or fiscal period if monthly profits are not ascertainable, with the amount of interest on bonds outstanding applicable to the month or fiscal period just ended, as the case may be. The corresponding credit is to Accrued Interest on Bonds.

Credit:

Balance of this account constitutes a fixed revenue charge, and should be transferred to Profit and Loss account when the books are closed.

The above applies with equal force to interest on outstanding mortgages. (See also Chapter XVIII.)

§ 88. Accrued Interest on Bonds*Debit:*

With payments of interest on bonds outstanding.

Credit:

At the close of each month, or fiscal period if monthly profits are not ascertainable, with the amount of interest accrued on outstanding bonds during the month or fiscal period just ended, as the case may be. The corresponding debit is to Interest on Bonds.

The balance of this account is a liability, and represents interest accrued and not due. (See also Chapter XVIII.)

The above applies with equal force to interest accrued on outstanding mortgages.

Since in most large corporations it is the practice to require monthly profit and loss statements and balance sheets, accrued interest on bonds, mortgages, and other obligations must be set up in the general ledger accounts.

§ 89. Sinking Fund

Debit:

With amount of moneys transferred from the general funds of the business to a special fund for the specific purpose of meeting some fixed obligation at a particular time, as a bond issue, mortgage, or other debt.

With the income derived from the investments of money set aside as a sinking fund. (At this time credit Sinking Fund Income account.)

Credit:

With amounts of money disbursed for the purpose for which the special fund was created.

The balance of this account is an asset and should at any time represent the accumulated value of the sinking fund. The moneys thus taken are usually handed over to a trustee or board of trustees for safe-keeping and investment, the duties of such trustee in respect of such funds being set forth in the document creating the trust. (See also Chapter XXI.)

§ 90. Sinking Fund Reserve

Debit:

With any deductions necessitated by loss or return of moneys credited.

With transfers or appropriations therefrom for other purposes or for the benefit of some other reserve.

With the balance when transferred from this account to Surplus account or to some other permanent reserve.

Credit:

With the amount appropriated out of profits at designated periods for the creation of a sinking fund, the corresponding debit being made to Profit and Loss account or to Surplus.

With all income derived from the deposit or investment of sinking fund moneys, as interest or dividends.

With any profit on sales of securities belonging to the fund.

This account shows a credit balance and represents a nominal liability. As the bonds for which the reserve was created mature and are paid off, this account should be transferred to Surplus or to some such permanent account as "Permanent Reserve" account, or "Surplus Not for Dividend Purposes."

A sinking fund reserve is seldom created nowadays, since its mission is taken care of by other means and by the maintenance of an adequate surplus (§ 82.) (See also Chapter XXI.)

§ 91. Sinking Fund Income

Debit:

With the transfer of income, monthly or yearly, to Profit and Loss or to Sinking Fund Reserve account.

Credit:

With any income in the shape of interest or dividends received from investment or deposit of sinking fund moneys, as reported by the sinking fund committee or trustee in charge of the sinking fund.

Income from sinking fund moneys, whether invested in securities or on deposit in the savings bank, is a profit to the corporation, and is usually credited to some representative account, as Sinking Fund Income, or Interest on Sinking Fund. This account is in turn closed into Profit and Loss, or Reserve for Sinking Fund in case the latter account is being carried. (See also Chapter XXI.)

§ 92. Good-will

Debit:

With the cost of good-will acquired.

Credit:

With any portion of good-will subsequently written off.

The balance of this account is an intangible fixed asset,

which ordinarily remains unchanged. Of late years, however, there has been a tendency to reduce the good-will from time to time by charges against Profit and Loss or Surplus.

Good-will is a thing to be acquired, and not created arbitrarily by a book entry. But because of the widespread practice of overcapitalizing which has grown up in corporate organizations, the Good-Will account is almost invariably the difference between the true value of the assets taken over and the value placed upon them by the board of directors, or acquiesced in by them. In other words, a Good-Will account is commonly used in the book accounts as an offset to overcapitalization of the tangible assets. It is then the difference between the actual property value of the issued stock of a corporation and the par value of that stock and, where this is excessive, may well be written down as the value of the tangible assets increases. (See also §§ 157-159.)

§ 93. Investment in Stocks and Bonds of Other Companies

Debit:

With the cost value of stocks or bonds of other corporations.

Credit:

With the sale of stocks or bonds previously debited.

The account shows a debit balance and is an asset. Such investments are usually made either for the purpose of investing surplus funds, or with the object of securing a controlling interest in some competing concern. Where both stocks and bonds are owned, it is advisable to open two separate accounts, or even to open an account for each kind, stating the name of the company in connection therewith, as "Stock of American Bridge Company," "U. S. Steel Bonds," etc. (See also Chapter VIII.)

Part III—Special Entries Relating to Transactions in Stock and Dividends

CHAPTER VII

STOCK OF ORIGINAL ISSUE

§ 94. General Conditions

In a partnership the investment consists of the cash or property contributed by the partners. In a corporation it consists of the proceeds of the stock sold. The interests of partners are represented by their capital accounts, while the interests of stockholders are represented by their stock holdings, or on the corporate books by their respective accounts in the stock ledger. In a partnership the profits are usually credited to the proprietors' accounts and remain there until drawn out according to agreement. The profits of a corporation are credited once a year or oftener either to Surplus account or to Undivided Profits account, until, when declared as dividends, they are credited to Dividend account, and are paid out as soon as the dividend is due.

The opening entries on the books of a corporation are determined by the conditions under which the stock is sold, and it is important that such entries should be complete and clear. They sometimes fail in this and are obscure because of insufficient data in the journal entries. This may be due to carelessness or ignorance, or occasionally to the desire of the incorporators to withhold certain facts regarding the

company's organization that might be used later to their disadvantage. As to this, it can only be repeated that all entries should tell the truth clearly and unmistakably; and it may be added that, no matter how cunningly such entries are devised, a competent accountant can always discover their true meaning.

Entries covering the various conditions of stock issues, as given in the present and the succeeding chapter, include the following:

1. Entries for original issues of stock sold under different conditions.
2. Entries relating to stock donated to the treasury.
3. Entries where an original issue of stock or treasury stock is given in direct payment of corporate obligations.
4. Entries relating to the purchase and sale by the corporation of its own stock (not an original issue), and of other stocks.

The entries given are intended merely to show the debits and credits directly resulting from the transactions considered. In practice all cash entries are, of course, recorded in the cash book and are thence posted to the proper ledger accounts; but throughout the present volume, for the sake of clearness the entire transaction is, in each case, expressed in the form of a journal entry regardless of whether it belongs in the cash book or journal, or should be divided between the two books. In this connection reference to the rules laid down in the preceding chapter should be made.

Many transactions encountered in opening corporate books admit of different treatment; and accordingly, in the following chapters it will be found that transactions identical in nature have been variously handled for purposes of exemplifying the different methods.

§ 95. Pro Forma Statement

The Davison Mercantile Company has been organized with a capital stock of \$200,000, divided into 2,000 shares of \$100 each. 1,500 shares were subscribed for at par,* as follows:

A. W. Davison.....	800 shares
George H. Brandon.....	300 “
R. S. Cooke.....	200 “
James Robinson.....	200 “

All subscriptions have been paid in cash, excepting that of Davison, who turned over merchandise on his subscription to the value of \$50,000 and paid the balance, \$30,000, in cash. The total cash paid into the treasury of the company is therefore \$100,000.

Two plans of opening the books of the Davison Mercantile Company are shown on the following pages. It is to be noticed that, in opening the journal of a new corporation under any plan, the first entry should be a reasonably complete statement of the conditions under which the corporation is organized, somewhat similar to that given in the two preceding paragraphs. This is desirable in order to bring together into one clear, concise statement, all the details of the incorporation required by the accountant, and to relieve the opening entries of the detail otherwise necessary. Without this *pro forma* entry as a basis, the explanation of the following journal entries would be too meager.

§ 96. Opening Entries—Stock Full-Paid (Plan 1)

Cash	\$100,000	
Merchandise	50,000	
To Capital Stock.....		\$150,000
Cash and property received by the Company		

* See subscription list (§ 55).

in full payment of subscriptions to its capital stock, as follows:

A. W. Davison.....	800 shares
George H. Brandon.....	300 “
R. S. Cooke.....	200 “
James Robinson.....	200 “

Merchandise to amount of \$50,000 was turned in by A. W. Davison as part payment of his subscription, the balance being paid in cash.

This opening entry is the simplest possible. Incoming cash and merchandise receive their proper debits, and capital stock is credited with the amount subscribed and paid for. In this case the cash item is entered in both the journal and the cash book, as is not uncommon in opening entries. To meet this condition, the general ledger item in the cash book entry is checked to indicate that it is not to be posted, and the cash item in the journal entry is likewise checked and not posted.

§ 97. Opening Entries—Stock Full-Paid (Plan 2)

As capital stock is credited with the amount of stock sold, the amount *unissued* may be readily determined under the entries of Plan 1, by subtracting the amount sold from the total capital stock. If it is thought preferable to have an account which shows the amount of stock unissued, Capital Stock is credited with the entire amount authorized, and the part not issued is debited to a separate account called “Unsubscribed” or “Unissued” Stock. Whether this is worth while is for the accountant to determine. Under this plan the opening entries of the Davison Mercantile Company would be as given below. Where there is more than one kind of stock issued, it is necessary, of course, to open an account for each.

First Entry

Subscribed Stock.....	\$150,000	
Unissued Stock.....	50,000	
To Capital Stock.....		\$200,000
The Davison Mercantile Company is organized with a capital stock of \$200,000, divided into 2,000 shares of \$100 each. 1,500 shares were subscribed for at par by the incorporators as follows:		
A. W. Davison.....	800 shares	
George H. Brandon.....	300 "	
R. S. Cooke.....	200 "	
James Robinson.....	200 "	

Unissued Stock is debited, as shown, with the entire balance of the unsubscribed stock, which remains there until sold or otherwise disposed of.

Frequently the entire authorized capital stock is first debited to Unissued Stock account and credited to Capital Stock Authorized account, thereby establishing an opening entry on the books. In that case, the above entry would be modified by a debit to Subscribed Stock, or Subscriptions, and a credit to Unissued Stock, for \$150,000; and when this amount is entirely paid, another entry would be made transferring the \$150,000 from Capital Stock Authorized to Capital Stock. This plan is in common use and is both simple and adequate for opening corporate entries.

Second Entry

Cash	\$100,000	
To Subscribed Stock.....		\$100,000
Payment of incorporators' subscriptions to stock as follows:		
A. W. Davison.....	\$30,000	
George H. Brandon.....	30,000	
R. S. Cooke.....	20,000	
James Robinson.....	20,000	

Third Entry

Merchandise	\$50,000	
To Subscribed Stock.....		\$50,000
Payment of balance of Davison's subscription to stock, paid in merchandise as per agreement.		

As will be noted, "Subscribed Stock" is debited with the full amount subscribed; and this having been paid, is credited with the same amount; the account then balancing and thus showing that all stock subscribed has been paid. Where subscriptions are not paid at once, or where they are paid in instalments, subscribers' accounts are sometimes opened in the general ledger; but in practice it is better to open individual accounts in a subsidiary ledger, letting "Subscribed Stock" account in the general ledger represent all these as a controlling account. When the number of subscribers is large, it is sometimes advisable to record them collectively in the ledger under "Subscriptions" account, as explained in § 74.

§ 98. Stock Sold on Instalments (Plan 1)

In accordance with the data furnished by the subscription list,* the Lancaster Cement Company was organized July 1, 1916, with a capital stock of \$1,000,000, one-half of which was subscribed for as follows:

Ronald Logan.....	1,000 shares
Samuel Bennett.....	1,000 "
A. W. Thompson.....	1,000 "
J. H. Connor.....	1,000 "
Oliver Ferguson.....	1,000 "

The terms of subscription are 10% down, 30% on July 21, and the remainder in two instalments as shown by the agreement.

*See § 55.

The instalment book* shows the method of recording calls for instalments. The first call was made by the trustee July 1; the second presumably upon final incorporation.

As one-half of the stock was subscribed at the time of organization, this amount may at once be entered upon the books as an asset, since it represents definite obligations due the company. Occasionally the Subscription account is omitted and no formal entry of the subscriptions made in the ledger beyond a credit to Capital Stock as each instalment is paid. In that case the entries given below would be omitted and only cash entries made, Cash being debited and Capital Stock credited. Sometimes the amount subscribed is credited to Capital Stock Subscribed account and when paid transferred to Capital Stock account.

First Entry

July 1, 1916

Subscriptions	\$500,000	
Unissued Stock.....	500,000	
To Capital Stock.....		\$1,000,000

The Lancaster Cement Company was organized on this date with capital stock of \$1,000,000, divided into 10,000 shares of the par value of \$100 each, one-half of which has been subscribed as per the following list. Terms of subscription are 10% on July 1, 1916, 30% on July 21, and the remainder in two instalments as per agreement.

Ronald Logan.....	1,000 shares
Samuel Bennett.....	1,000 "
A. W. Thompson.....	1,000 "
J. H. Connor.....	1,000 "
Oliver Ferguson.....	1,000 "
	<u>5,000</u> "
Unissued	<u>5,000</u> "
Total.....	<u>10,000</u> "

*See § 58.

The amount subscribed being now entered upon the books, the next step is to make entries for the instalments as they come due, the Instalment account being debited and Subscriptions credited. The accounts of subscribers must be shown either in the subscription ledger, the instalment register, or the general ledger. Sometimes they are placed in the back of the general ledger, but if they are numerous it is advisable to place them in a separate book. Of course, the total of the balances of these accounts must agree with the balance of the Subscriptions account in the general ledger, which is the controlling account. If the number of subscribers is large, an instalment sheet is made out, as shown in § 58.

Second Entry

July 1, 1916

Instalment No. 1.....	\$50,000	
To Subscriptions.....		\$50,000
First instalment for 10% of \$500,000 subscriptions, as per subscription list and instalment book.		

As the payments are made they are credited to the individual accounts and also to Subscriptions account in the general ledger, or to the Instalment account when that is used. The latter plan is shown below, though instead of opening an account for each instalment, an account for "Subscribers" might be opened each time an instalment is due, as shown in § 74.

The following entries assume that all the subscribers pay the instalment. If this is not the case, the actual amount received will be entered, leaving a balance due in Instalment No. 1.

Third Entry

July 1, 1916

Cash	\$50,000	
To Instalment No. 1.....		\$50,000
For payment of first instalment of 10%.		

Fourth Entry

July 21, 1916

Instalment No. 2.....	\$150,000	
To Subscriptions.....		\$150,000
For second call, 30% on total subscriptions of \$500,000.		

Fifth Entry

July 21, 1916

Cash	\$150,000	
To Instalment No. 2.....		\$150,000
For payment of second instalment of 30%.		

§ 99. Stock Sold on Instalments (Plan 1)—Ledger Accounts

The general ledger accounts resulting from the foregoing entries are as follows:

CAPITAL STOCK

	1916	
	July 1	Authorized.. \$1,000,000.00

SUBSCRIPTIONS

1916	1916
July 1	July 1
Capital Stock.. \$500,000.00	Instalment No. 1 \$50,000.00
	“ 21 Instalment No. 2 150,000.00

UNISSUED STOCK

1916	
July 1	Capital Stock.. \$500,000.00

INSTALMENT NO. 1—10%

1916	1916
July 1	July 1
Subscriptions.. \$50,000.00	Cash \$50,000.00
	(If not all paid a balance will result.)

INSTALMENT No. 2—30%

1916 July 21 Subscriptions \$150,000.00	1916 July 21 Cash\$150,000.00 (If not all paid a balance will result.)
--	--

CASH

1916 July 1 Instalment No. 1 \$50,000.00 " 21 Instalment No. 2 150,000.00	
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If the names are not too numerous or the instalments too frequent, each instalment account might include on the debit side the names of subscribers and the amount due from each; though this is not necessary, as all this information is clearly set forth on the instalment sheet or book.

§ 100. Stock Sold on Instalments (Plan 2)

In this case Capital Stock account exhibits only the capital actually contributed, being increased for each instalment paid in, and also for any subsequent sales of stock of original issue. The entry of unissued stock is manifestly out of the question under this plan of entry, since it is neither an asset nor a liability.

First Entry—First Instalment

July 1, 1916	
Subscribers	\$50,000
To Capital Stock.....	\$50,000

The Lancaster Cement Company was organized on this date with capital stock of \$1,000,000, divided into 10,000 shares of the par value of \$100 each, one-half of which has been subscribed as per the list given below. Terms of subscription are 10% on July 1, 1916, 30% on July

21, and the remainder in two instalments as per agreement. First instalment, 10% on \$500,000, now due.

(List of subscribers)

Second Entry

July 1, 1916		
Cash	\$50,000	
To Subscribers.....		\$50,000
For payment of first instalment.		

Third Entry—Second Instalment

July 21, 1916		
Subscribers	\$150,000	
To Capital Stock.....		\$150,000
For second call, 30% of \$500,000.		

Fourth Entry

July 21, 1916		
Cash	\$150,000	
To Subscribers.....		\$150,000
Payment of second instalment of 30%.		

If thought advisable, the journal entries might be omitted and, the Subscribers' account being eliminated, only cash book entries be made, crediting Capital Stock; but this does not permit the full explanations which can be so conveniently placed in the journal.

§ 101. Sale of Stock After Organization

The statutes of the various states usually require that when a company is organized some portion of its stock shall be issued, or at least subscribed for, before active operations are begun. Some of the capital stock must, of course, be sold before the company can exist as an active business organization; but beyond these statutory requirements, the whole matter is one for the corporation itself to

decide, and the capital stock may be all issued at the time of organization or part be held for future use in case the immediate needs of the company are provided for. This unsubscribed or unissued stock is sometimes (though inappropriately) called "treasury stock" (§ 27).

Assuming that on August 1, 1916, \$100,000 of the unissued stock of the Lancaster Cement Company has been sold at par to Frank K. Brennan, one-half for cash and one-half in 30 days, the following entries would be required:

August 1, 1916		
Subscriptions (or Frank K. Brennan).....	\$100,000	
To Unissued Stock.....		\$100,000
The Lancaster Cement Company has this day sold to Frank K. Brennan \$100,000 of its unissued stock, one-half payable in cash and the balance in 30 days.		

August 1, 1916		
Cash	\$50,000	
To Subscriptions (or Frank K. Brennan)		\$50,000
First payment of 50% on Brennan's stock subscription.		

August 31, 1916		
Cash	\$50,000	
To Subscriptions (or Frank K. Brennan)		\$50,000
Final payment of 50% on Brennan's subscription to \$100,000 of stock.		

It is apparent that the method of recording entries in this case will be governed by the original plan of opening entries, as the various entries should, of course, harmonize.

§ 102. Stock Sold Below Par

As already stated, when stock on its original issue is sold below par, it may involve the purchaser in liability for

the unpaid balance. (See § 26.) Occasionally, however, stock is sold on original issue at less than par regardless of this liability. This may be all right if not prohibited by the state law; but it is obvious that the liability for the unpaid balance still attaches to such stock so long as it is in the hands of the original purchasers or those who purchase from them with knowledge of the conditions.

To illustrate the entries in such case, assume that on August 15, 1916, \$100,000 of the unissued stock of the Lancaster Cement Company is sold to Henry Jones for \$80,000, payable \$40,000 on date of purchase, and the balance in one month. The entries are then as follows:

August 15, 1916

Henry Jones.....	\$80,000	
Discount on Stock.....	20,000	
To Unissued Stock.....		\$100,000
For sale of 1,000 shares of unissued stock to Henry Jones at \$80 per share, payable \$40,000 down and the balance in one month.		

August 15, 1916

Cash	\$40,000	
To Henry Jones.....		\$40,000
First payment on subscription to 1,000 shares of stock.		

September 15, 1916

Cash	\$40,000	
To Henry Jones.....		\$40,000
Balance of payment on subscription to 1,000 shares of stock.		

The Stock Discount account now remains open upon the books and should either be closed into Profit and Loss during the year, or spread over a term of years; or the

directors may appropriate enough of the surplus profits in the form of a dividend to wipe it off entirely. It is prudent in any case to get rid of it as soon as possible so as to remove from the records an undesirable item. In the following entry it is closed into Profit and Loss.

Profit and Loss.....	\$20,000	
To Discount on Stock.....		\$20,000
To close Stock Discount account into Profit and Loss—entry made by order of the board of directors.		

The above entry will suffice, perhaps, in case the profits are ample to take care of it; but, if by this disposition a deficit is created in the Profit and Loss account, nothing has been gained by the transfer.

§ 103. Stock Sold Above Par

It is but seldom that stock in a newly organized company sells for more than its face value. Occasionally, however, where the new company takes over valuable property, or its organizers are men known to be successful and its purpose is attractive, subscriptions are taken at more than par.

After a company has been organized and has achieved success, its stock, if offered for sale, is usually for the purpose of raising money to extend the business, purchase new properties, or do something else distinctly advantageous to the corporation. In such cases the stock is frequently worth more than par, and the right of purchase is usually offered first to the stockholders, who are privileged to buy all or part of the issue at par or at a given figure above par. Such privileges have a distinct value, and it is not unusual for rights of this kind in the larger corporations to be traded in freely.

When a corporation sells its stock at a premium, the

proceeds in excess of the par value are credited either to Premium account or to Surplus account, and represent profits. Speaking generally, however, it would be of doubtful wisdom for the directors to distribute such premiums in the form of dividends, even though they may have the technical authority to do so.

To illustrate the accounting treatment of premiums, assume that \$100,000 face value of the unsubscribed stock of the Lancaster Cement Company has been sold November 1, 1916, to George Bowers for \$120,000, payable \$50,000 at date of purchase and the balance in one month. The entries for the transaction would be as follows:

November 1, 1916

George Bowers (or Subscriptions).....	\$120,000	
To Unissued Stock.....		\$100,000
" Stock Premium.....		20,000

The Lancaster Cement Company has this day sold to George Bowers \$100,000 of its unissued stock for \$120,000; \$50,000 is payable on the day of purchase, and the balance in 30 days.

November 1, 1916

Cash	\$50,000	
To George Bowers.....		\$50,000
First payment on account of subscription to stock.		

December 1, 1916

Cash	\$70,000	
To George Bowers.....		\$70,000
Balance due on account of subscription to stock.		

The premium may stand in the Stock Premium account, or be transferred to Surplus or to a permanent reserve account; or it might be reserved for the extinguishment of some doubtful or wasting asset, as good-will, plant, or some

machine or patent right. In case it were transferred, Stock Premium account would, of course, be debited and the account to which it is transferred be credited.

§ 104. Stock Issued at a Premium to Create a Surplus

In the previous illustration the stock of an established company was sold at a premium. It is not unusual for a corporation to sell its stock above par at the time of incorporation, for the purpose of creating a surplus—a practice which is usually followed by insurance companies, banks, trust companies, and other financial institutions. A company with a substantial surplus is more likely to possess the confidence of the public than one that has none; and by selling stock at a premium a more or less substantial surplus or margin is provided at the outset, which may be drawn upon to meet organization expenses, and carry the company and give it solidity until it becomes firmly established.

When stock is thus sold at a premium, the entries are the same as in any other sale above par. For example, if a share of stock is sold for \$150, the par value, \$100, might be credited to Unissued Stock or Capital Stock, and the \$50 to Premium or Surplus.

There are material advantages in this plan of selling stock, especially in the case of a national bank, where a double liability is attached by statute to every share of its stock. If the stock is sold at a premium sufficient to meet the statutory liability, not only is this liability provided against, but the bank is given a substantial and desirable addition to its working capital.

In any such case the premium is credited to Surplus. Thus, assume that the Second National Bank of Shawmut has been incorporated with a capital stock of \$250,000, all of which has been sold at a premium of 50%. The book entry would appear as follows:

Cash	\$375,000	
To Capital Stock.....		\$250,000
" Surplus		125,000
The Second National Bank of Shawmut incorporated with capital stock of \$250,000, has on this date sold the same at a premium of 50%.		

This contributed surplus remains on the books as a credit to Surplus account.

§ 105. Payment of Salaries in Stock

Not infrequently the salaries of managers and officers of corporations are paid wholly or partly in stock. The procedure is not improper under suitable conditions, and the entries are simple. It is in effect a payment of salaries in cash which is subsequently returned as payment for stock. Such stock salaries might be paid monthly if so agreed, but even when based on monthly instalments, they are usually allowed to accumulate till the end of the year or longer, before an issue of stock is made. In any case, a debit will be made to the proper salary account or else to expense account, and a credit of the full face value of stock issued made to Capital Stock, Unissued Stock, or Treasury Stock, according to the conditions and the method of entry. If the stock is not taken at its par value, any excess over par is credited to Surplus, or, if taken below par, the difference between this price and par is debited to Surplus.

§ 106. Payment of Commissions in Stock

Commissions paid in stock are of common occurrence in the promotion or organization of a company, and they create no unusual bookkeeping entries. If paid by issue of original stock, Commission account (or such other expense account as commissions may be charged to) is debited, and Capital Stock or Unissued Stock account is credited; pay-

ments from treasury stock are similarly debited and are credited to "Treasury Stock." Indeed, there is no objection to the liquidation of any debts by stock, so long as the capital is not impaired by so doing, i.e., so long as a fair equivalent is received for the issued stock. An existing mortgage or even a loan or current debt might be cancelled by means of a stock issue, provided the creditor were willing to accept it as a substitute for cash. Dividends are frequently paid in stock, such dividends being known as "stock dividends" (§ 131).

CHAPTER VIII

TREASURY STOCK AND STOCK OF OTHER COMPANIES

TRANSACTIONS IN TREASURY STOCK

§ 107. Donated Stock

In speculative companies, donations of stock to the treasury (see § 27) are customary, and give rise to some of the most unsatisfactory entries of corporate bookkeeping.

Any donation to a commercial undertaking is anomalous, but when it takes the form of stock just issued (and hence of unknown value) by the very corporation to which it is donated, the transaction is entirely outside the realm of ordinary business and its proper entry is difficult. The object of such a donation of stock has already been stated (§ 27). The newly organized corporation requires stock which can be sold below par without carrying with it a liability. Treasury stock supplies this need, and so long as the laws relating to full-paid stock exist in their present form, so long will transactions in donated stock continue.*

When a corporation reacquires its own stock, whether by donation or purchase, this stock becomes, from the accounting standpoint, an asset, and is debited to "Treasury Stock" at the price paid if the stock is purchased, or at its estimated value if it is donated. The corresponding credit in the case of stock purchased for cash is, of course, to Cash account, but in the case of donated stock the account

*Under the New York law permitting corporations to issue stock without par value, stock so issued may be sold at any desired price without liability.

to be credited will vary according to the method of record adopted.

§ 108. Donated Stock—First Method of Entry

Under this method, if a corporation is organized with a capital stock of \$75,000, all of which is issued in payment for property, and stock of the face value of \$10,000 is returned to the company to be sold to secure operating capital, the entries, assuming the stock to be salable at par, will be as follows:

Treasury Stock.....	\$10,000	
To Donation Account (or Working Capital		
Donated).....		\$10,000
Stock donation of 100 shares to be sold to provide working capital.		

When the stock is sold, the following entry is required:

Cash	\$10,000	
To Treasury Stock.....		\$10,000
For 100 shares of treasury stock sold at \$100 per share.		

The "Donation" account is then closed into Surplus account as follows:

Donation Account.....	\$10,000	
To Surplus.....		\$10,000
Closing Donation account into Surplus.		

This gives the corporation an apparent profit of \$10,000. Whether such a surplus is a real profit applicable to dividends must be decided, according to conditions, by the directors of the particular corporation. As a matter of fact, such a surplus is practically taken out of capital and its use for dividends is of doubtful propriety. If the stock was donated to provide working capital, the use of its proceeds for dividends would be manifestly improper.

Donated stock can rarely be sold at par, and it is entered at the time it is received, at such price as the corporate authorities think it will produce. Thus, in the case instanced, if instead of \$100 per share the stock were expected to bring but \$50 per share, it would be entered upon the corporate books as follows:

Treasury Stock.....	\$5,000	
To Donation Account.....		\$5,000
For 100 shares of stock donated to treasury for the purpose of securing working capital; estimated value, \$50 per share.		

When the stock is sold at the estimated price, the other entries are similar to those given, Cash being debited, Treasury Stock credited with the amount received, and Donation account closed into Surplus. If, however, the stock when sold produced a larger price than was expected, say \$60 per share, the cash entry would be as follows:

Cash	\$6,000	
To Treasury Stock.....		\$5,000
" Donation Account.....		1,000
For 100 shares of stock donated to treasury and sold at \$60 per share.		

This gives a total credit in Donation account of \$6,000, which is the amount actually realized on the donated stock. Donation account is then closed into Surplus by a journal entry.

If, on the other hand, the treasury stock sold at less than the estimated value, say, for instance, \$40 per share, the cash entry would be as follows:

Cash	\$4,000	
To Treasury Stock.....		\$4,000
For 100 shares donated to treasury and sold at \$40 per share.		

The difference between the estimated value and sale price of the stock is then debited to Donation account as follows:

Donation Account.....	\$1,000	
To Treasury Stock.....		\$1,000
For 100 shares of stock donated to treasury and entered at \$50 per share, but sold at \$40 per share.		

This shows a credit balance in Donation account of \$4,000, which is the real value of the stock donated, and the account is then closed into Surplus. The same end might, of course, be attained by the single entry which follows:

Donation Account.....	\$5,000	
To Surplus		\$4,000
" Treasury Stock.....		1,000

§ 109. Donated Stock—Second Method of Entry

The objection to the first method of recording donated stock lies in the fact that it shows an apparent profit before active corporate operations have begun, or even before the company has become well established. At this stage, when the corporation's sole assets are the property taken over and the stock which has been donated to it (the value of which really rests upon this same property), any profits shown could hardly be other than fictitious; certainly not unless the property for which the stock was originally issued was actually worth as much or more than the face value of the stock, in which case a real profit from donated stock would result. In practice, the value of property taken over by a corporation is seldom conservatively estimated, and the apparent profits from donated stock are therefore usually fictitious and misleading.

Under the second method of entry, donated stock is considered as a concession on the price of the property for

which it was issued, and the value of the returned stock is accordingly credited to this same property account. This reduces the book cost of the property to the corporation, but does not show the immediate and usually fictitious profit that is shown by the first method of entry. The method is therefore more conservative than the one first presented and is to be preferred, especially in cases where the property was overvalued at the time of incorporation.

Thus, if a corporation is formed with a capital stock of \$100,000 and this entire amount is issued in payment for patent rights, and \$25,000 face value of this stock is then returned to the corporation, the entries under the second method would be as follows:

Patent Rights.....	\$100,000	
To Capital Stock.....		\$100,000
Entire capital stock issued in exchange for patent rights. See page ... of minute book.		

When the donation of \$25,000 face value of the stock is received, it is credited to "Patent Rights" at the price at which it is expected to be sold. Thus, if the \$25,000 face value of stock returned was expected to bring \$50 per share, the entry would be as follows:

Treasury Stock.....	\$12,500	
To Patent Rights.....		\$12,500
For 250 shares of stock valued at \$50 per share, donated to treasury for purposes of the corporation.		

If this stock is sold at the price expected, the cash entry would show the following debits and credits:

Cash	\$12,500	
To Treasury Stock.....		\$12,500
For 250 shares of treasury stock sold at \$50 per share.		

If, however, the stock should sell at more than \$50 per share, say \$60 per share, the excess must go to Patent Rights in order to show the true rebate or concession made on the price. The entry would therefore be as follows:

Cash	\$15,000	
To Treasury Stock.....		\$12,500
" Patent Rights.....		2,500
For 250 shares of treasury stock sold at \$60 per share. Originally credited to Patent Rights at \$50 per share.		

Likewise, if the stock sold at less than \$50 per share, say \$40, the deficiency must be debited to Patent Rights, as shown in the following entry:

Cash	\$10,000	
Patent Rights.....	2,500	
To Treasury Stock.....		\$12,500

This reduces the net credit on patent rights to the amount actually realized from the sale of the treasury stock.

The advantage of the second method of handling donated stock lies in its conservative presentation of the conditions. Under the first method, as already stated, a profit is shown before the corporation has even begun its active operations. Under the second method, no immediate profit is shown as a result of the stock donation. Perhaps at some later date when the books are balanced, an inventory of the property will show a value in excess of its cost; this gain is real, and might then—unless conservative accounting practice prohibits—properly be transferred to Surplus.

An objection sometimes urged against the second method of entering donated stock is the fact that the entry may, by inference, cast some reflection upon the directors' usual statement in their resolution of acceptance, that the property "is of the reasonable value of the stock issued therefor."

This is a matter for the treasurer of the corporation and the directors to consider and decide for themselves. The objection has no legal weight.

§ 110. Bonus Paid in Stock

Stock given in bonuses is issued without any direct consideration, and as an extra inducement to purchasers. Such issues are not necessarily improper as they usually promote the sale of bonds, preferred stock, or other securities, and thus directly benefit the corporation. The particular stock given as a bonus, however, apparently goes without direct consideration, and will, as a matter of course, be taken from treasury stock. A "Bonus" account is opened, and the entries are made on the basis of the price at which the stock was debited to Treasury Stock account.

Thus, if \$10,000 face value of common stock is given from treasury stock as a bonus to the purchasers of a like amount of preferred stock, and this common stock had been debited to Treasury Stock account at 50 cents on the dollar, the entry would be as follows:

Bonus	\$5,000	
To Treasury Stock.....		\$5,000
For 100 shares of stock originally entered at \$50 per share, given as a bonus with 100 shares of preferred stock sold at par.		

Bonus account would thereafter be treated as part of the organization expenses which are generally written off over a period of years.

Original stock might be issued as bonus stock so long as no one offers objection, but, since it would not in that case be full-paid stock, the holders would remain liable to corporate creditors for the full face value in case of insolvency. In any such case the outgoing stock would be

debited to Bonus account and credited to Capital Stock or Unissued Stock, as the case might be.

§ III. Purchase and Sale of Corporation's Own Stock

A corporation may issue its capital stock in exchange for cash, property, or services. It does not, however, as a rule have the right to purchase back such stock without statutory or special permission from the state in which it was incorporated; and even then, charter authority or sanction of the stockholders may be required. This is so because the purchase of its own stock by a corporation is practically a reduction of its capital stock, and such a reduction can be effected only by permission of the state and by following the legal procedure prescribed.

There are many instances of companies having purchased their own stock, but the authority under which it is done can be determined only after an inspection of the statutes of the particular state and the charter and by-laws of the particular corporation. Sometimes an issue of preferred stock provides for its redemption or repurchase at specified dates or periods, or at the option of the company officials. When such an issue is contemplated, a careful investigation should be made to determine whether the proposed redemption is legally possible.

When a company purchases its own stock, it is not usually as an investment, but in pursuance of some pre-arranged plan or for the protection of its own interests in some way. Stock so secured should be charged to Treasury Stock. Stock bought back does not have the voting right while in possession of the corporation, nor may it participate in dividends.

Stock which has come back into the possession of a company may, as a rule, be sold again on the open market. As to whether or not it may be sold at a discount depends

upon circumstances. It is apparent that it may not be resold for less than it cost if such sale would impair the capital. This would not, of course, be the case with stock, which has already been issued full-paid and then donated back to the company. Stock cancelled for non-payment of instalments may be resold, but the selling price should be high enough to bring, in connection with any payments already received, at least the par value of the shares involved.

§ 112. Entries for Purchase and Sale of Corporation's Own Stock

To illustrate the accounting treatment of transactions in a company's own stock, suppose that a company has purchased 500 shares of its full-paid stock for \$45,000, and that after holding it for a time, 250 shares have been resold for \$25,500 (200 shares for \$20,000, and 50 shares for \$5,500). Later the company made two sales of 125 shares each at \$90, closing out the balance of the stock. The entries are as follows:

First Entry

Treasury Stock.....	\$45,000	
To Cash.....		\$45,000
For purchase of 500 shares full-paid stock of this Company at \$90 per share.		

Second Entry

Cash	\$25,500	
To Treasury Stock.....		\$25,500
For the sale of 250 shares of treasury stock. 200 shares @ 100 and 50 shares @ 110.		

The third and fourth entries recording the further sales would be similar to the second entry, varying only as to amounts.

Fifth Entry

Treasury Stock.....	\$3,000	
To Profit and Loss (or Surplus).....		\$3,000
For profits realized on the purchase and sale of treasury stock.		

Profits of this nature, while technically available for dividends, are preferably credited to Surplus or held in some special reserve account.

TRANSACTIONS IN STOCK OF OTHER CORPORATIONS

§ 113. Purchase and Sale of Stock of Other Corporations

A corporation may acquire the stock of another corporation only when it is expressly authorized to do so by its charter or by the statutes of the state. But cases have frequently arisen in which the circumstances were such that the courts have sanctioned such purchases—as, for instance, stock held as security for a debt and bought in—even though both the law and the charter of the corporation were silent in this respect. Permission to purchase stocks of other companies is given by the statutes of several of the states, but it is usually required that the stock thus purchased shall not be that of a competing company. In some cases it is left to the incorporators themselves to define in the charter to what extent securities of other companies may be held or purchased. In New York, power is granted corporations to hold stock in similar or related corporations by proper charter provisions; and when one corporation holds stock in another, its directors or officers are eligible as directors in the other corporation but they cannot vote the stock of any competing corporation. Similar power is given in New Jersey, Pennsylvania, Illinois, and many other states, while in some states such purchase of stock is prohibited. New Jersey corporations are given unrestricted authority to purchase stocks of other corporations.

In some states "holding companies" may be organized, whose purpose is not to carry on any active business, but merely to purchase and hold the stocks, bonds, and securities of other corporations, the same as individuals might. The "holding company" secures a controlling interest in its subsidiary companies, which has the effect of merging or consolidating all of the separate operating companies under one management, and it derives its revenue entirely from the dividends on the stock of these underlying companies. The United States Steel Corporation is a holding company, and owns the stock of various underlying companies which in turn are known as "operating companies." (See Chapter XXXI.)

When stock of another corporation is purchased, it is not treasury stock of the corporation which acquires it, but an investment, and goes into an entirely separate and distinct account headed "Investments," or "Stocks of Other Companies," or some other distinguishing caption. If bonds are included in the purchase, the account might be headed "Securities of Other Companies," or else "Stocks and Bonds of Other Companies"; or separate accounts might be opened for each class of security or even for each security. Such investments are usually entered up at the cost price, and, when sold, at the selling price. The profit or loss sustained as a result of the sale will, of course, be closed into the Profit and Loss account.

§ 114. Entries for Purchase and Sale of Stock of Other Corporations

To illustrate the entries involved, assume that the American Trading Company has purchased \$300,000 par value of stock of the Baldwin Mercantile Company for \$250,000. It later disposes of \$40,000 face value of this stock for \$50,000, thereby netting a profit of \$10,000. Later the

Baldwin Mercantile Company declares a 6% dividend. The following entries are required for proper record of the transactions in stock:

Stocks of Other Companies (or "Stock of Baldwin Mercantile Company").....	\$250,000	
To Cash.....		\$250,000
For purchase of \$300,000 par value of stock of the Baldwin Mercantile Company.		
Cash	\$50,000	
To Stocks of Other Companies.....		\$50,000
For sale of \$40,000 par value of stock of the Baldwin Mercantile Company.		
Stocks of Other Companies.....	\$10,000	
To Profit and Loss (or Surplus).....		\$10,000
For profit on sale of \$40,000 of stock in Baldwin Mercantile Company.		

The second and third entries could easily be combined. When the 6% dividend is declared by the underlying company and paid over to the holding company, an entry similar to the following is required:

Cash	\$15,600	
To Income Account (or "Dividends on Investments")		\$15,600
For dividend of 6% on \$260,000 par of stock of the Baldwin Mercantile Company.		

§ 115. Entries When Stock Is Exchanged for Stock of Other Corporations

In cases where the purchase of securities in other corporations is sanctioned by statute or by charter, the manner of making payment is usually left to the contracting parties. The stock of another company, instead of being purchased for cash, might therefore, if the state laws permit, be ob-

tained in exchange for the stock of the acquiring company.

To illustrate the entries when this is done, assume that the Delaware Manufacturing Company has been organized with a capital stock of \$1,000,000, comprising 10,000 shares of the par value of \$100 each, of which 1,000 shares have been subscribed and paid for in cash. Additional stock of the company has been disposed of as follows:

1. 3,000 shares in exchange for 2,500 shares of stock, \$100 each, of the Hudson Manufacturing Company.
2. 1,000 shares in exchange for 1,200 shares in the Superior Textile Company.
3. 1,000 shares in exchange for 1,000 shares in the Brown Cloth Company.
4. 1,000 shares in exchange for 500 shares of the Southern Cotton Company.

First Entry

Unissued Stock.....	\$1,000,000	
To Capital Stock.....		\$1,000,000
The Delaware Manufacturing Company is incorporated with an authorized capital stock of \$1,000,000.		

Second Entry

Cash	\$100,000	
To Unissued Stock.....		\$100,000
For 1,000 shares of stock sold for cash to the following persons: (Names stated)		

Third Entry

Stocks of Other Companies.....	\$300,000	
To Unissued Stock.....		\$300,000
For purchase of 2,500 shares of the Hudson Manufacturing Company in exchange for 3,000 shares of this Com- pany.		

Fourth Entry

Stocks of Other Companies.....	\$100,000	
To Unissued Stock.....		\$100,000
In exchange for 1,200 shares of the Superior Textile Company.		

Fifth Entry

Stocks of Other Companies.....	\$100,000	
To Unissued Stock.....		\$100,000
In exchange for 1,000 shares of the Brown Cloth Company.		

Sixth Entry

Stocks of Other Companies.....	\$100,000	
To Unissued Stock.....		\$100,000
In exchange for 500 shares of the Southern Cotton Company.		

Entries 3 to 6 inclusive might easily be consolidated. It will be seen that the stock has been issued at par and that each lot of stock in other companies has been valued at the par value of the stock given for it. The unsold stock, numbering 3,000 shares, the par value of which is \$300,000, will stand as a debit balance to Unissued Stock until sold.

CHAPTER IX

DIVIDENDS AND THEIR ENTRY

§ 116. The Nature of Dividends

Dividends are corporate profits which have been set aside by formal action of the directors for distribution among the stockholders. The corporate books are periodically balanced, the profits determined, and the directors then decide what portion, if any, of these profits shall be withdrawn for division among the stockholders. If a dividend is voted, or as it is termed, "declared," it is in the shape either of a percentage on the par value of the outstanding stock, or a fixed amount on each share. The amount received by each stockholder is therefore determined by the number of shares he holds.

§ 117. Directors' Powers as to Dividends

It is a well-recognized principle of law that the directors of a corporation, alone, have the power to declare a dividend out of the earnings of the corporation and to determine its amount. This right of directors is incident to their general power to manage the affairs of the corporation, and is recognized either directly or by implication by the laws of every state in the Union. The right is, of course, subordinate to any statutory, charter, or by-law provisions which may apply; but beyond this the whole matter is in the discretion of the board of directors.

Usually in small companies the by-law provisions relating to dividends merely provide that dividends shall be declared from surplus profits at such times as the board may direct. The by-laws of the larger companies, however, are

generally more explicit, as for example, directing the board—if profits permit—to declare dividends on the first of each year, or at the regular meetings in January and July, or on some other specific date.

If the directors, at the regular time for declaring a dividend, decide not to declare one, they are said to have “passed the dividend.”

§ 118. Informal Distribution of Corporate Profits

Corporate profits are occasionally distributed among stockholders without the formality of declaring a dividend—a valid proceeding if all the stockholders consent. Where the corporation is small, the distribution of profits is sometimes effected without recourse to dividends, by means of salaries which therefore sometimes appear unreasonably large. In such cases all the stockholders are usually also officials of the corporation, and thus all participate in this informal division of profits. This plan is permissible only when all the parties interested assent and no improper ends are to be attained thereby. When, however, such salaries are paid for the sake of concealing profits, with a more or less fraudulent intent, the courts hold them as “dividends of profits under another name, put in that guise for concealment and delusion.” (*Rubber Co. v. Goodyear*, 9 Wall [N. Y.] 788 [1869].)

§ 119. Surplus—Equalizing Dividends

While dividends must, if declared, be declared from earnings, the capital being kept intact for the protection of the creditors of the corporation, it is not obligatory on the directors to distribute all the net profits and it would be poor policy to do so. A surplus should be accumulated to meet unexpected losses and for other unforeseen contingencies. When this is done, if it seems wise, this surplus

may be drawn upon to pay dividends in poor years when the profits are not sufficient for that purpose, and in this way dividends be equalized. The advantage of this is obvious.

§ 120. Declaration of Dividends

Dividends may be declared payable to the stockholders of record on and after the day of the declaration, or on a specified later day, but could not be declared payable to the stockholders who were of record on a day prior to the announcement. This is obvious, as such stockholders might no longer be stockholders when the dividend was declared.

Many companies close the transfer books for a certain number of days before payment of dividends, so as to avoid the confusion occasioned by making transfers before all of the dividend checks are made out; and during that period refuse to recognize any change in the ownership of stock. (See § 62.) Other companies make it a point to announce in their dividend notices that "books will not close" or "books will remain open." During the days the transfer books remain closed, stock of the company which is sold goes "ex-dividend," that is, without the dividend. In other words, the dividend will not be paid to the purchaser, but to the one in whose name the stock stands on the company's books.

A customary form of the resolution of the board of directors declaring a dividend is as follows:

RESOLVED, that the regular semiannual dividend of four per cent (4%) from surplus profits be and hereby is declared upon the common stock of the Company, payable upon the 20th day of October, 1916, to the stockholders of record as shown by the books of the Company on the 10th day of January, 1916, and that the Treasurer of the Company be and hereby is authorized and directed to pay said dividend in accordance with the terms of the present resolution.

Resolution Declaring Dividend

§ 121. Notice of Dividend

Among the smaller corporations the secretary usually sends notice to the stockholders when a dividend is declared, notifying them of the rate and sometimes the amount, date of payment, and any other details of importance. A notice of this kind may be either printed or typewritten.

Among the larger corporations it is usual, after passing the resolution declaring a dividend, to publish a notice of this dividend in the daily papers. The following is a typical dividend notice:

FULTON COAL COMPANY
GENERAL OFFICE, READING TERMINAL
PHILADELPHIA

July 17, 1916

The Directors have declared a dividend of fifty cents (50c) per share, payable on Monday, July 24, 1916, to the stockholders as they stand registered on the books of the Company at the close of business July 17, 1916.

The transfer books of the Company will be closed until July 25, 1916.

W. G. BROWN,
Secretary

Dividend Notice—Publication

§ 122. Ownership of Dividends

When a dividend from the net profits of a corporation has once been legally and publicly declared, it cannot thereafter be rescinded or annulled, but its amount is immediately transferred from the corporate ownership to the ownership of the stockholders; and this principle holds even though at the time it was declared no definite date was fixed for its payment. If, however, a dividend has been declared but this fact has not been made public, being known only to the directors, they may rescind it. Also, if it were illegal, a dividend formally declared and announced might be revoked at any time before payment. Should the board, for

example, declare a dividend in defiance of or in ignorance of the fact that there were no profits from which it might legally be taken, they might revoke it at any time before it was actually paid.

As soon as the day appointed for payment of a dividend is reached, the dividend becomes due and payable, and the stockholders can enforce its payment by legal procedure.

§ 123. Payment of Dividends

When a dividend is declared, its amount is credited to Dividend account (§ 83) and debited to Profit and Loss or Surplus. In the smaller corporations dividends are usually paid by check on the general bank account, just as in the case of any other company payment. Cash account is credited and Dividend account debited as the dividend checks are drawn. In the larger corporations it is usual to draw one check payable to the bank for the total amount of the dividend, and this check is entered in the cash book and posted to Dividend account in the ledger. This closes the account, and the general books of the company are no longer concerned with that particular dividend, no matter how long some of the stockholders may hold their dividend checks before getting them cashed.

The check for the total dividend is deposited in the bank to the credit of a special account—as for instance, “Kingston Steel Works—Dividends” or “William Kingston, Treasurer”—or even in another bank than that in which the corporation keeps its main deposit, and the individual dividend checks are drawn on this account, using a special check book. These are mailed or otherwise delivered to their owners, and, from the bank’s statement of the dividend account, it can be seen at any time which stockholders have not, up to that time, drawn their money. This need not concern the general books of the corporation, however, be-

cause the entire matter is now outside the usual course of business; and even though there are outstanding unpaid dividend checks, the balance in the account need not necessarily show on the balance sheet.

Instead of the plan just outlined some (though few) large corporations make no entries for dividend payments on the cash book until the dividend checks are paid at the bank. As reports are received from the bank, entries are made debiting Dividend account and crediting Cash.* Under this plan the credit balance of the Dividend account will show at any time the amount of the dividend still unpaid. It is not unusual for dividend checks to remain unpaid for a considerable time or even indefinitely, in which case this plan of recording dividend payments has some advantages. The Cash account in this case is also made to show its correct status, so that dividend checks outstanding do not have to be deducted in arriving at the correct balance of the dividend cash.

The larger corporations with many stockholders usually have specially printed dividend checks, giving the date and number of the dividend. By means of an addressing machine, the name and address of the stockholder are stamped on the face of the check in the lower left hand corner, after which the amount is filled in on the typewriter or other printing machine. After the checks and amounts are verified, proved on the adding machine, and signed by the proper officials, they are placed in window envelopes for mailing.

§ 124. Dividend Sheet or Book

The practice of setting aside each quarter or half-year in a separate bank account the exact amount required for the payment of dividends, and drawing special checks against this fund, keeps dividend cash entirely separate from the

*Daily statements are received from the bank along with cancelled checks from the previous day.

general cash of the company. A dividend sheet or book similar to those on pages 139, 140, should be prepared each time, showing the names of stockholders, date of dividend, amount and number of each check, etc. As the checks are paid a record may be made in this book, if desired, but where the names are numerous this is hardly worth while.

The dividend sheet or book contains a list of the stockholders entitled to receive dividends. This list is usually made up from the stock ledger each time a dividend is declared, after the transfer books are closed, though in the case of companies with but few stockholders this is not necessary. When the stockholders are many and the stock active, it is very necessary that these lists be compiled, and that care be taken in checking up and proving the amounts which are to be paid.

The bound dividend book is used, if at all, only by small companies whose stock is not active; the larger corporations using loose sheets and placing them in binders for convenience. These sheets, if bound together, would constitute the ordinary dividend book. Two forms of dividend sheet are shown on pages 139, 140, illustrating two methods of paying dividends.

Where stockholders come to the office of the corporation or to the bank for their dividends, a space is allowed on the dividend sheet for their signatures. Some companies prefer this plan as it keeps the stockholders in touch with the corporation and its business. Most companies, however, have adopted the plan of mailing all dividend checks, and these are always made payable to order. The indorsement of the check is then considered a sufficient receipt, and the receipt column is unnecessary.

§ 125. Entries for Cash Dividends

To illustrate a simple form of entering cash dividends.

suppose the net profits of the Kingston Steel Works for the year 1915 amounted to \$38,690.40. The directors have declared the regular annual dividend of 5% on the \$500,000 of outstanding paid-up capital stock, payable in cash in ten days, the remaining profits going to surplus. The dividend is the seventh annual dividend that has been declared.

The entries for the declared dividend and for paying it are as follows:

January 7, 1916		
Profit and Loss.....	\$38,690.40	
To Dividend No. 7.....		\$25,000.00
" Surplus		13,690.40
Seventh annual dividend of 5% on the outstanding capital stock of the Com- pany declared this day by the board of directors and payable January 17, 1916.		

January 17, 1916		
Dividend No. 7.....	\$25,000	
To Cash.....		\$25,000
For payment of dividend No. 7, as per order of the directors.		

In many cases no Dividend account is opened, in which case the dividends paid are charged direct to Profit and Loss or to Surplus account, the entries for the foregoing transaction being as follows:

January 7, 1916		
Profit and Loss.....	\$38,690.40	
To Surplus.....		\$38,690.40
January 17, 1916		
Surplus	\$25,000	
To Cash.....		\$25,000
Payment of the seventh annual dividend of 5% on the outstanding stock of the Company, declared January 7, 1916, and payable January 17, 1916.		

If a special bank account is set apart for dividend checks, the transfer of dividend cash is made as explained in § 123, by drawing one check for the required amount, Dividend or Surplus account being debited and Cash credited. The individual checks are then issued by the officers in charge of the dividend disbursements.

When dividends are paid quarterly, the current credit entries to Dividend account are sometimes omitted entirely, the cash payments being debited to Dividend account, which once or twice a year is closed into Surplus account.

§ 126. Dividends Paid with Borrowed Money

It is not unusual for even the most prosperous company to be temporarily short of ready cash to meet dividend payments. The current assets may be three times as much as the current liabilities, and yet consist largely of notes and accounts receivable which cannot be used to pay dividends. In such a case it is perfectly proper for the directors to borrow money to pay a dividend. In that event the following entries might be made, the first a journal entry, all the others cash book entries:

First Entry

January 4, 1916

Surplus	\$10,000	
To Dividend Payable.....		\$10,000
Dividend of 5% declared this day on capital stock of the Company. Payable in cash January 15, 1916.		

Second Entry

January 13, 1916

Cash	\$10,000	
To Notes Payable.....		\$10,000
Three months' note discounted at First National Bank to secure funds for payment of dividend due January 15.		

Third Entry

January 13, 1916		
Discount	\$150	
To Cash.....		\$150
Discount at 6% on Company's three months' note of \$10,000.		

Fourth Entry

January 15, 1916		
Dividend Payable.....	\$10,000	
To Cash.....		\$10,000
Payment of dividend of 5% on capital stock of the Company.		

§ 127. Entries for Scrip Dividend

Another way to pay a dividend when temporarily short of cash is by an issue of scrip. Scrip is a promissory note of a corporation, usually bearing interest, and falling due upon a specified date, or after a specified occurrence, as for instance when a proposed bond issue shall have been sold. The scrip is in the form of certificates, on which appear the company's promise to pay the money and the various terms of the contract. These certificates sometimes call for or are convertible into stock of the company, and such scrip sometimes participates in dividends. The scrip certificates are frequently transferable, and pass by assignment from hand to hand in the open market.

The Novelty Manufacturing Company with a capital stock of \$1,500,000, \$1,000,000 being common stock and \$500,000 preferred stock, declares its regular annual dividend of 3% on both issues, payable in scrip. Dividend declared May 15, 1916, payable June 15, 1916; scrip payable in cash June 15, 1917.

The journal entries for the declaration and payment of this annual 3% scrip dividend on the common and preferred stock are as follows:

First Entry

May 15, 1916

Surplus	\$45,000	
To Dividend—Common		\$30,000
“ Dividend—Preferred		15,000
Annual dividend of 3% on both common and preferred stock declared this day, payable June 15, 1916, in scrip of the Company, maturing June 15, 1917 and bearing interest at 5%.		

Second Entry

June 15, 1916

Dividend—Common	\$30,000	
Dividend—Preferred	15,000	
To Dividend Scrip (or Scrip Payable)...		\$45,000
Dividends paid this day in scrip maturing June 15, 1917 and bearing interest at 5%.		

When the scrip matures, an entry similar to the following is necessary:

June 15, 1917

Dividend Scrip.....	\$45,000	
Interest	2,250	
To Cash.....		\$47,250
For payment of dividend scrip maturing to-day, with interest from June 15, 1916 at 5%.		

§ 128. Entries for Special and Interim Dividends

Occasionally, after a very prosperous year or a longer period of prosperity, during which a large surplus has been accumulated, the directors declare a “special dividend” or “bonus” in addition to the regular dividend. This is commonly called “cutting a melon.” Sometimes the employees of the company are given a portion of the “melon,” in which case the process is known as “profit-sharing.”

To illustrate the entry of such dividends, assume that a

corporation with \$1,000,000 capital stock, and profits for the year of \$125,400, declares its regular annual dividend of 7% and at the same time declares a "special dividend" of 2%, and awards to its employees a bonus of 10% of the net earnings of the year just ended. The entries are as follows:

January 4, 1916

Surplus	\$102,540	
To Dividend No. 17.....		\$70,000
" Special Dividend No. 1.....		20,000
" Bonus to Employees.....		12,540

As per resolution passed this day by the board of directors declaring the regular annual dividend of 7% on the capital stock of the Company; an additional dividend of 2%; and awarding to the employees a bonus of 10% of the net earnings of the year just ended; all payable in cash on the 15th day of January, 1916.

January 15, 1916

Dividend No. 17.....	\$70,000	
Special Dividend No. 1.....	20,000	
Bonus to Employees.....	12,540	
To Cash.....		\$102,540

For payment of dividends and bonus provided for in resolution of the board of directors passed January 4.

Dividends declared between the regular dividend dates are called "interim dividends," and are declared when unusual profits exist to justify a special dividend, or when for some reason it is desired to anticipate the regular dividend in whole or in part. When dividends are paid quarterly, as is the case with most of the larger corporations, an interim dividend is seldom if ever declared. The entries in case of interim dividends, would of course be identical to those of a regular dividend.

CHAPTER X

DIVIDENDS AND THEIR ENTRY (Continued)

§ 129. Entries for Dividends Applied to Stock Subscriptions

As a declared dividend is a debt due from the corporation to the stockholder, any indebtedness of a stockholder to the corporation may be set off against his dividend and be deducted from it, provided the debt is actually due at the time the dividend is payable. Accordingly, the corporation has full power to apply dividends in payment of amounts due on subscriptions to its stock.

It may be noted that a contract between the corporation and a subscriber to its stock providing that his subscription shall be paid by dividends on the stock subscribed for, is absolutely invalid both as against the corporation and against corporate creditors. Under such an agreement, any credits of declared dividends actually made would be held a valid payment, but in case of the insolvency of the corporation before the stock was full-paid, the stockholder could be called upon to pay in cash all amounts still due on his subscription, and this regardless of the agreement that it was to be paid by dividends.

To illustrate the entries when dividends are to be applied on a stock subscription, let us suppose that \$200,000 par value of new stock of the Kanawha Iron Works (shares \$50 each) has been offered for sale to provide funds for the erection of additional buildings; that all this has been sub-

scribed, and a first instalment of 50% has been paid upon it. John Smith is a subscriber for 10 shares. On January 5, 1917, the board of directors passes a resolution calling for the final instalment of 50% on the entire subscribed stock, payable February 1. On February 3, at which time John Smith has not paid the final instalment on his stock, the directors declare an annual dividend of 5% on the entire outstanding stock (\$500,000) as of January 1, payable February 15. The entries for these transactions are as follows:

First Entry

January 5, 1917

Final Instalment on Stock (or Instalment No. 2)	\$100,000	
To Subscriptions.....		\$100,000
As per resolution passed this day by the board of directors, calling for the final instalment of \$100,000 on \$200,000 of capital stock of the Company.		

This entry will close the Subscription account, substituting for it the Final Instalment account. Assuming that all the stockholders have paid the first instalment in full, the First Instalment account is already closed.

Second Entry

February 1, 1917

Cash	\$99,750	
To Final Instalment on Stock.....		\$99,750
Payment of final instalment on capital stock.		

This, of course, would be comprised in cash book entries showing the names of the stockholders and amount paid by each. To simplify the illustration, it is assumed that all except John Smith had paid at the time of declaring the dividend.

Third Entry

February 3, 1917

Surplus	\$25,000	
To Dividend No. 5.....		\$25,000
The board of directors have this day declared the regular annual dividend of 5% on the capital stock of the Company, payable in cash on the 15th day of February.		

Fourth Entry

February 15, 1917

Dividend No. 5.....	\$24,975	
To Cash.....		\$24,975
Dividend paid this day as per resolution of the board of directors, February 3.		

Fifth Entry

February 15, 1917

Dividend No. 5.....	\$25	
To Final Instalment on Stock.....		\$25
To apply dividend of John Smith as part payment of final instalment of \$250 due on 10 shares of capital stock of the Company.		

§ 130. Entries for Cumulative Dividends

Preferred dividends for the current year must be paid before dividends may be paid the holders of common stock; and if the preferred stock is "cumulative," all dividends on it which have been "passed" in former years must also be paid in full before the common stock can participate. If the provisions by which the preferred stock is created do not state whether it is cumulative or non-cumulative, it is treated as cumulative.

To illustrate the difference between the two kinds of stock, suppose a company with preferred stock calling for 7% dividends has "passed" all dividends for two years, and at the end of the third year desires to pay a dividend on the common stock. If the preferred stock is cumulative, it will first have to pay all the "passed" dividends on the pre-

ferred stock amounting to 14%, and the current dividend as well—21% in all; while, if the preferred stock is non-cumulative, it need only pay the current dividend of 7%.

Although the preferred stock dividends must be paid before the common stock can receive any share of the profits of the corporation, these dividends do not become an obligation of the company until they are formally declared by the board of directors. It would seem, therefore, to be poor accounting to enter them on the books as an obligation at the time they are "passed," although this is sometimes done. It is necessary, however, that the unpaid cumulative dividends be shown on the balance sheet, and this is best done by means of a footnote stating the contingent liability for the dividends which have been "passed."

Where a preferred dividend is passed but it is desired that it be shown on the books, it may be done by an entry similar to the following:

Surplus	\$30,000	
To Unpaid Preferred Dividend.....		\$30,000
For 1916 preferred dividend of 6% not declared by the board of directors but ordered to be shown upon the books.		

This might make the Surplus account show a debit balance, and in any event it would be reducing surplus for the sake of a liability which was only contingent. Instead of charging the dividend against surplus, it might therefore be a better plan to set up the following nominal asset account to offset the contingent liability of the unpaid preferred dividend:

Dividends—Preferred Stock.....	\$30,000	
To Unpaid Preferred Dividends.....		\$30,000
For 1916 preferred dividend of 6% not declared by the board of directors but ordered to be shown upon the books.		

§ 131. Entries for Stock Dividends

Sometimes the directors declare instead of a cash dividend, what is known as a "stock dividend." There may be stock in the company's treasury, donated or purchased, that may properly be divided among the stockholders in the form of a dividend. Or unissued stock may be issued for the purpose, or new stock may even be created. The directors are perfectly justified in using such stock for dividends, provided there are undivided profits of an amount equal to the face value of the stock issued as dividends. To illustrate the entries, suppose that the Michigan Furniture Company, with an authorized capital stock of \$1,000,000, has had a very prosperous year, its profits amounting to over \$100,000, but the directors desire to invest most of their available funds in additional shops and machinery. Their regular annual dividend is 10%. Only one-half of the authorized capital stock has been issued, so they declare the regular 10% dividend but make it payable in stock of the company.

First Entry

Surplus	\$50,000	
To Dividend No. 4.....		\$50,000
A dividend of 10% on the \$500,000 outstanding capital stock of the Company has this day been declared by the directors, payable in stock of the Company.		

Second Entry

Dividend No. 4.....	\$50,000	
To Capital Stock.....		\$50,000
Stock issued to pay stock dividend of 10%.		

If the unissued stock is being carried on the books in Unissued or Unsubscribed Stock account, the second entry would be a credit to that account. If the dividend were paid out of treasury stock, Treasury Stock account would, of course, be credited.

§ 132. Entries for Bond Dividends

Corporate bonds may, at the discretion of the directors, take the place of cash in the payment of dividends, provided only that they are issued against actual profits. In other words, if there are profits from which dividends may be legally paid, the directors may pay them in cash, in stock, in bonds, or in any other available property owned by the corporation. To payment in bonds, however, there are two practical objections which do not exist in the case of stock dividends: (1) bonds bear interest which becomes a fixed charge as soon as it is due, and (2) they are an absolute obligation of the corporation which must be paid at maturity.

It is not unusual for short term notes or debenture bonds to be issued in payment of dividends where it seems preferable to conserve the cash for working purposes; but even this is a somewhat extreme measure unless it be for payment of cumulative dividends.

Suppose that in the preceding example the directors, with the consent of the stockholders, had paid the dividends in bonds, the entries would be as follows:

Surplus	\$50,000	
To Dividend No. 4.....		\$50,000

A dividend of 10% on the capital stock of the Company has this day been declared by the directors, payable in the first mortgage treasury bonds of the Company.

Dividend No. 4.....	\$50,000	
To First Mortgage Treasury Bonds.....		\$50,000

First mortgage 4% treasury bonds given to stockholders in payment of 10% dividend on the stock of the corporation.

§ 133. Bank Dividends

Banks pay dividends on their stock with checks drawn on themselves (cashiers' checks), and this makes the book-keeping entries slightly different from those of other companies. The first entry is:

Undivided Profits.....	\$50,000	
To Dividend No. 34.....		\$50,000
For dividend of 5% declared this day by the directors on the capital stock of the bank.		

The charges to Dividend account come from the cash book as the dividend checks are presented for payment at the paying teller's window or through the clearing house. The balance of Dividend account, therefore, shows the amount of dividend checks outstanding, and appears on the balance sheet as "Unpaid Dividends."

§ 134. Property Dividends

Dividends, as already stated, may consist of any kind of corporate property, though, except in the case of corporate securities, there are obvious difficulties in the way of distribution which make such dividends rare. Thus, a company whose profits were in land might divide this land among its stockholders as a dividend, if it were practically possible, and no objection could be raised. The more usual form of property dividend is, however, that of securities of other corporations purchased at some previous time for investment, or received when the corporation sells rights of some kind to another corporation, taking the stocks and bonds of that other corporation in payment. In 1916 one of the great manufacturers of war supplies paid a dividend in Anglo-French 5% Bonds.

Property dividends are also declared when a corporation is liquidated, all of its property, perhaps, having been ex-

changed for stock or bonds, or both, of the purchasing company. In this case the distribution is not, strictly speaking, a payment of dividends, but is a distribution of assets, and the ordinary rule that dividends may be declared only from profits does not apply.

§ 135. Unearned Dividends

Although the laws of all of the states forbid the payment of dividends if such payment results in the impairment of capital, there are more or less frequent evasions of this rule. The fact that a dividend has been paid out of capital may not be known to anyone except the directors; in fact, the directors themselves are sometimes ignorant of such an occurrence, owing to the fact that they will not take the trouble, or have not sufficient knowledge of accounting, to inform themselves of the true condition of the company. Yet they may be held liable by the courts for any loss to creditors occasioned by the payment of dividends out of capital.

Errors as to profits may arise from many causes. The books of the company may perhaps show a surplus of earnings which in reality does not exist, because no provision has been made for bad debts or depreciation; or materials have been included in the inventories which have not yet been credited to Accounts Payable; or materials have been valued at the selling price; or orders for future delivery may have been booked as sales; the book value of real estate may have been written up; assets with no value, such as patents and copyrights which have expired, may still be carried upon the books; judgments against the company may have been omitted from the accounts. These and other errors may have been made which hide the fictitious character of the apparent profits, so that the payment of dividends under such conditions results in an impairment of capital. An ex-

amination by a competent auditor, however, would disclose any such errors and prevent the declaration of illegal dividends.

In case dividends were declared which impaired the capital, and the company were forced into the hands of a receiver or into bankruptcy before the deficit was made up, the directors would be personally liable for the amount of the illegal dividends.

In case accounting errors are discovered which have resulted in a fictitious surplus, the proper charges must be made to show the true condition. This may, if dividends have been declared or other expenditures have been made on the strength of the supposed surplus, result in a debit balance in Surplus account. It is perfectly proper to allow this debit balance to remain on the ledger until wiped out by the accumulating profits, but in the balance sheet it should be placed on the asset side and called "Deficit"; yet in financial statements it is not unusual to see it deducted from the capital stock.

CHAPTER XI

PROPRIETORSHIP INCORPORATED (NEW YORK)

§ 136. Organization Procedure

The organization details outlined in Chapters XI to XIII are in accordance with the laws of the states in which the corporations discussed are respectively incorporated. Of course, an attorney will be retained when an incorporation is to be made, and on him rests the direct responsibility for the technical details; but the accountant should have at least a general knowledge of the required procedure.

In New York the procedure in organizing a corporation is that which obtains in a majority of the states of the Union, and for this reason the present chapter discusses the formation of a New York corporation in detail.

§ 137. General Provisions

A New York corporation need not limit itself to one object as in Pennsylvania and some other states, but may be formed to carry on as many different kinds of ordinary business as are set forth in the certificate of incorporation. The application for charter—which becomes the certificate of incorporation when allowed and filed by the Secretary of State—must be signed by three or more incorporators, who must be natural persons of full age, at least two-thirds of them citizens of the United States, and at least one a resident of the State of New York. Each incorporator must subscribe for one or more shares of stock.

An organization tax of $1/20$ of 1% of the total authorized capital stock must be paid to the State Treasurer. The Secretary of State's fee for filing the certificate of incorporation is \$10, and for recording, 15 cents per folio of 100 words. The fee of the county clerk for filing the certificate is 6 cents, and for recording, 10 cents per folio.

There are frequently, of course, other expenses incident to incorporation, which must be assumed by the incorporators or by the attorney in charge, and for which they bill the corporation after its organization.

§ 138. Financial Details of the Incorporation

Charles W. Hampton has been conducting a wholesale and retail mercantile business for the past ten years in the City of New York. He wishes to bring other parties into the business, and with this in view has decided to incorporate as of June 4, 1916, under the name of the "Hampton Trading Corporation," with a capital stock of \$250,000, consisting of 2,500 shares of the par value of \$100 each. The shares have been subscribed for as follows:

Name	Address	Shares	Amount
Charles W. Hampton	New York City	1,250	\$125,000
Samuel Johnson	"	500	50,000
James J. Miller	"	500	50,000
Lincoln Webster	Albany, New York	100	10,000
Robert W. Kester	"	100	10,000

Hampton is to receive 1,250 shares of full-paid stock in exchange for his business, buildings, stock, and equipment, including the various assets and liabilities as per the accompanying balance sheet. The business of Hampton is to be taken over as soon as possible after the first meeting of the directors, at which time the other subscribers to the stock of the company will pay 50% of their subscriptions, the remainder to be paid August 9, 1916.

CHARLES W. HAMPTON
BALANCE SHEET, AS OF JUNE 1, 1916

<i>Assets</i>	<i>Liabilities</i>
Real Estate:	Mortgage on Warehouse \$25,000.00
Land, Store, and	Loans from Bank..... 10,000.00
Warehouse \$80,000.00	Notes Payable..... 17,750.00
Store Equipment..... 8,500.00	Accounts Payable..... 22,800.00
Delivery Equipment.... 9,000.00	
Office Equipment..... 4,400.00	Total Liabilities.... \$75,550.00
Merchandise 46,300.00	Charles W. Hampton:
Accounts Receivable... 16,400.00	Capital Account..... 100,000.00
Notes Receivable..... 9,350.00	Personal Account... 5,140.00
Cash 6,740.00	
<u>\$180,690.00</u>	<u>\$180,690.00</u>

NOTE: A good-will of \$19,860 is to be included in the above to provide full payment for \$125,000 of stock in the new company.

§ 139. Certificate of Incorporation

This is usually executed in duplicate, signed by at least three subscribers to the stock of the proposed corporation, and then duly acknowledged by them before a notary. The directors for the first year are named in the certificate, and, if the certificate or by-laws so provide, directors need not be stockholders. The certificate of incorporation must contain:

1. The name of the proposed corporation, which must indicate that it is a corporation and must not conflict with that of any existing corporation.
2. The purpose or purposes for which it is to be formed.
3. The amount and kind of capital stock.
4. The number of shares, each of which shall not be less than \$5 nor more than \$100; and the amount of capital, not less than \$500, with which it will begin business.

5. The location of the principal business office.
6. Its duration, which may be perpetual.
7. The number of directors (not less than three).
8. The names and post-office addresses of the directors for the first year.
9. The names and post-office addresses of the subscribers to the certificate, and the number of shares which each agrees to take in the corporation.

The certificate should also set forth if power is desired to hold the stock of other corporations; if cumulative voting is desired; if the voting power of the stockholders shall be limited in any way, and that directors need not be stockholders, if this is desired. It may also contain any provisions for the regulation of corporate affairs, and any desired limitations on the powers of the directors and stockholders which do not conflict with the laws.

The charter of the Hampton Trading Corporation will be found in the Appendix, Form 1.

§ 140. Filing the Certificate of Incorporation

One of the duplicate originals of the charter is sent to the Secretary of State at Albany with a check or money order for the amount of the filing and recording fees (§ 137).

At the same time a check or money order for the organization tax (§ 137) is sent to the State Treasurer at Albany. The Secretary of State, if he finds the certificate of incorporation to be in proper shape, notifies the State Treasurer, who issues duplicate receipts for the organization tax, one of which he delivers to the Secretary of State, forwarding the other to the person who paid the tax. The Secretary of State then records the certificate of incorporation and gives notice of its filing to the person from whom it was received.

The other duplicate original certificate of incorporation, signed and acknowledged as was the original, must be filed in the office of the clerk of the county in which the principal office is located. To this must be attached the duplicate receipt for organization tax received from the State Treasurer, and the certificate must be accompanied by the proper fees.

The formal incorporation of the company is now completed. Frequently an extra copy of the original certificate of incorporation is forwarded to the Secretary of State at the same time the original is sent, with the request that he certify and return it. The fees for such certification are 15 cents for each 100 words, and \$1 for affixing the seal. This gives a certified copy which is legal evidence of the due incorporation of the company.

§ 141. First Meeting of Stockholders

There is no statutory or other requirement that a meeting of the stockholders be held as a part of the organization procedure, as the directors for the first year are named in the charter and these directors have, in all ordinary cases, full power to do everything necessary to organize the company. It is, however, customary for the incorporators—who are the subscribers to the stock of the corporation mentioned in the certificate of incorporation, and who become the legal stockholders of the corporation as soon as the charter is granted—to meet when the certificate has been filed in the county clerk's office. At this meeting by-laws are adopted, and resolutions are passed authorizing the issue of stock for cash or for property, or both. When property is to be taken over in payment for stock, a stockholders' resolution authorizing the exchange and the acceptance of the property by the directors, though not essential, is desirable.

§ 142. Minutes of First Meeting of Stockholders; By-Laws

The first meeting of stockholders is, as intimated, ordinarily a mere formal affair, at which by-laws already prepared are adopted and such other action is taken as may have been previously agreed upon. The first meeting of stockholders is usually assembled by means of a written "Call and Waiver of Notice." The minutes of the first meeting of stockholders of the Hampton Trading Corporation are shown in Form 4 of the Appendix. Proxy for this meeting is shown in Form 5; call and waiver of notice, in Form 6.

The by-laws shown in Form 2 of the Appendix, while brief, are sufficient for the needs of any corporation of medium size. They meet the requirements of the New York statutes, and may be adapted to meet any special requirements of other states or of corporations of other purposes. For large corporations more elaborate forms of by-laws are required, in which the details of corporate procedure are set forth much more fully. Such by-laws may be found in any of the standard works on corporate organization and procedure.*

Occasionally a certified copy of the by-laws is required, or extracts from them must be certified. In such case, the general form of certification shown in Form 3 of the Appendix will usually be found sufficient.

§ 143. Minutes of First Meeting of Directors; the Stock Book

The first meeting of directors usually follows closely the first meeting of stockholders. The minutes shown in Form 7 of the Appendix cover in detail the usual procedure.

The procedure outlined completes the organization of the company: the business of Hampton has been taken over

*See Conyngton's "Corporate Organization."

in payment for stock, the first instalment on stock subscriptions has been received, and the various organization expenses have been paid. It is now necessary to complete the official records and make the opening entries in the books of account.

The New York statutes require that every stock corporation shall keep at its office correct books of account of all its business and transactions, and a book to be known as the stock book (§§ 65, 66), containing the names, alphabetically arranged, of all persons who are stockholders of the corporation, their place of residence, the number of shares of stock held by each, the date of purchase, and the amount paid thereon. Also the statutes require that this stock book shall be open daily during at least three business hours, for the inspection of the corporation's stockholders and judgment creditors, who may make extracts therefrom. The corporation or officers refusing or neglecting to exhibit the books or permit extracts to be taken therefrom as provided by the statutes, are liable to a penalty of \$50 for each day of neglect or refusal.

The proper stock book entries should be made at the time the stock certificates are issued, and afterward at the time transfers are made. The form of stock book to be used in New York is prescribed by the Comptroller and is shown in § 66.

§ 144. Journal Entries

The opening entries in the books of account should now be made, according to the plan adopted by the accountant. A matter of prime importance here is the inclusion of adequate and complete explanations. Vague or incomplete records should not be tolerated.

In the opening entries which follow, the accounts of incorporators are entered in the general ledger. This would

not be advisable if the number of incorporators or subscribers to be entered were large. Other opening entries which accomplish the same end in a somewhat different manner will be found in Chapter VII, "Stock of Original Issue."

The following entries for stock subscriptions and for taking over the assets and liabilities in payment are made as of June 9, 1916, the date of organization:

June 9, 1916

Charles W. Hampton.....	\$125,000	
Samuel Johnson.....	50,000	
James J. Miller.....	50,000	
Lincoln Webster.....	10,000	
Robert W. Kester.....	10,000	
Unissued Stock.....	5,000	
To Capital Stock.....		\$250,000

Hampton Trading Corporation, incorporated
with an authorized capital of \$250,000,
divided into 2,500 shares of \$100 each,
subscribed for as follows:

Charles W. Hampton.....	1,250 shares
Samuel Johnson.....	500 "
James J. Miller.....	500 "
Lincoln Webster.....	100 "
Robert W. Kester.....	100 "
Unissued Stock.....	50 "

Subscriptions payable 50% in cash and
balance August 9, 1916.

At the time of incorporation, certain necessary expenses must be advanced by the incorporators or by the attorney in charge. These are reimbursed after organization. All cash entries are given in the cash book shown below. The only remaining journal entry required is that recording the transfer of assets and liabilities from Hampton to the corporation, as follows:

Plant and Sundry Assets.....	\$200,550	
To Sundry Liabilities and Subscription..		\$200,550

Assets

Real Estate.....	\$80,000
Store Equipment.....	8,500
Delivery Equipment.....	9,000
Office Equipment.....	4,400
Merchandise	46,300
Accounts Receivable.....	16,400
Notes Receivable.....	9,350
Cash	6,740
Good-Will	19,860

Liabilities and Subscription

Mortgages Payable.....	\$25,000
Bank Loans.....	10,000
Notes Payable.....	17,750
Accounts Payable.....	22,800
Charles W. Hampton.....	125,000

For the entire assets and liabilities of Charles W. Hampton, taken over this day in full payment of his subscription. A good-will of \$19,860 is allowed over and above the net worth indicated by his balance sheet. (See minutes of stockholders and of directors for authority and for further details.)

As will be seen, the cash turned over by Hampton is included in the journal entry, in order to show all of the assets and liabilities together. This plan, which obviates the necessity of splitting entries, is to be favored for it sets forth the entire transaction. The cash account is ticked in the journal, and the general ledger account in the cash book, to indicate that they are not to be posted. If this were not done, the items might be posted from both books.

CASH BOOK

1916		1916	
June 9	Samuel Johnson	June 9	Organizing Expenses :
	(Paid on June		Organization
2)	\$500.00		Tax
Charles W.			\$125.00
Hampton (Bal-			Filing Certifi-
ance trans-			cate
ferred)	6,740.00		10.00
Samuel Johnson.	24,500.00		Recording Fees
James J. Miller..	25,000.00		20.00
Lincoln Webster.	5,000.00		Counsel's Fee..
Robert W. Kes-			250.00
ter	5,000.00		Accountant's
(Payment of first			Fee
instalment of			250.00
50% on sub-			Other Outlays.
scriptions to			200.00
stock.)			Balance
			65,885.00
	<u>\$66,740.00</u>		<u>\$66,740.00</u>

The necessary entries have now been made in the journal and cash book, and the accounts called for by these entries must be opened in the general ledger. An account should also be opened for unissued stock. The subscribers' accounts will be credited and cash debited, through the cash book, when the final payments are made August 9, 1916.

There is nothing unusual in the form of any of these ledger accounts and they are not shown here in account form.

In the stock ledger, records of the stock holdings of each subscriber must appear. Instalment receipts must be issued as payments are received, and stock certificates made out when the final payments are made. It is the duty of both the attorney and accountant to see that the general procedure is in accordance with legal and business requirements.

CHAPTER XII

MANUFACTURING AND MINING CORPORATIONS

MANUFACTURING CORPORATION

§ 147. Details of Incorporation

The preliminary organization of the Rockwell Manufacturing Company, of Philadelphia, Pennsylvania, is effected March 2, 1916. The company is to be incorporated for the manufacture and sale of household furniture, with a capital stock of \$100,000, consisting of 1,000 shares of the par value of \$100 each. The incorporators and the number of shares subscribed for by each are as follows:

Name	Address	Shares	Amount
George Rockwell	657 Broad St., Philadelphia	400	\$40,000
Jane Rockwell	657 Broad St., Philadelphia	200	20,000
Henry Lindon	1415 Market St., Philadelphia	300	30,000
Thomas J. Peterson	Harrisburg, Pa.	100	10,000

The first instalment of 10%, as required by the Pennsylvania law, has been paid in cash. Immediately after the date of final organization, another payment of 50% will be due, and the balance will be payable one month thereafter.

§ 148. Statutory Records

After the organization has been completed and all requirements complied with, it is in order to make the necessary records in the books of the corporation. In Pennsylvania the statutes provide that either the treasurer or secre-

tary shall keep at the office of the principal place of business a book containing the names of all persons who are, or who within one year shall have been, stockholders of such company, showing the number of shares held, when they became owners thereof, the amount paid in, etc. This book is to be open for inspection during business hours. It is obvious that the stock ledger shown in § 66 would meet the statutory requirements.

§ 149. The Books of Account

Books of account are not prescribed by statute, but a complete set of books should be provided, and they must, of course, be properly kept. The opening entries for journal and cash book are shown on the following pages, including payment of the first and second subscription instalments and the customary expenses at the time of incorporation. Accounts with stockholders must be opened in the stock ledger, instalment receipts issued, and the stock certificate book made ready for use as soon as the instalments are completed.

§ 150. Journal Entries

For opening entries, the plan that will best suit the case of the particular corporation should be adopted. Since there are only a few subscribers to stock, separate subscription and instalment registers are not necessary, as their names can be entered in the subscription and instalment accounts.

It will be noted that the first cash was received March 2, 1916, the date of application for charter. Since, however, the corporation does not come into legal existence until the charter is granted, it would seem desirable to make the opening entries on March 23, the actual date of organization. Entries should state all details fully, however, and give the dates of any payments already made.

First Entry

March 23, 1916

Subscriptions	\$100,000	
To Capital Stock....		\$100,000
Incorporation of the Rockwell Manufacturing Company with a capital stock of \$100,000, shares \$100. Subscriptions as below (under date of March 12, 1916) on terms of 10% down, 50% on date of organization, and the balance in one month:		
George Rockwell.....	400 shares	
Jane Rockwell.....	200 “	
Henry Lindon.....	300 “	
Thomas J. Peterson.....	100 “	

The first instalment of 10% having been paid at the time of incorporation, is entered directly in the cash book, as shown herewith. Next, under the same date, make an entry for the second instalment as below. The first instalment might, of course, be put through the journal in like manner, but, as it has already been paid, the cash book entry would seem to be all that is necessary. We might also omit the entry for Instalment No. 2 and let that likewise be credited to Subscriptions through the cash book.

Second Entry

March 23, 1916

Instalment No. 2.....	\$50,000	
To Subscriptions.....		\$50,000
For second instalment, being 50% of the amount subscribed:		
George Rockwell.....	\$20,000	
Jane Rockwell.....	10,000	
Henry Lindon.....	15,000	
Thomas J. Peterson.....	5,000	

Also, if an instalment register (§ 58) is used, the

journal entries for instalments would usually be omitted, and payments credited directly to Subscriptions account through the cash book. When Instalment No. 3 becomes due in one month, it will be treated in the same manner as Instalment No. 2.

To complete the accounting records it is not necessary to open accounts for the individual stockholders in the stock ledger, though this might be necessary in some states to comply with the statutory requirements. A stock account for George Rockwell follows:

[illegible]

Stock Ledger Account

Stock certificates should not be issued until the final instalment is paid.

§ 151. Cash Book Entries

CASH BOOK

<i>Receipts</i>	<i>Payments</i>
1916	1916
Mar. 2 Subscriptions, 10% paid in by: George Rock- well \$4,000.00 Jane Rockwell 2,000.00 Henry Lindon 3,000.00 Thomas J. Peterson ... 1,000.00	Mar. 23 Incorporation Expenses: Charter Fee..... \$30.00 Bonus on Capital 200.00 Recording Fees.. 2.50 Counsel 100.00 Accountant 100.00 Equipment 100.00 Expenses 35.00
Mar. 23 Instalment No. 2, 50%: George Rock- well 20,000.00 Jane Rockwell 10,000.00 Henry Lindon 15,000.00 Thomas J. Peterson ... 5,000.00	

§ 152. The Ledger Accounts

CAPITAL STOCK

	1916
	Mar. 23 Subscriptions \$100,000.00

SUBSCRIPTIONS

1916	1916
Mar. 23 Capital Stock: George Rock- well \$40,000.00 Jane Rockwell 20,000.00 Henry Lindon 30,000.00 Thomas J. Peterson... 10,000.00	Mar. 2 Cash, 10%.....\$10,000.00 Mar. 23 Instalment No. 2, 50%..... 50,000.00

INSTALMENT No. 2—50%

1916	1916
Mar. 23 Subscriptions, 50% :	Mar. 23 Cash .....\$50,000.00
George Rock-	(Payment may
well .....\$20,000.00	be credited
Jane Rockwell 10,000.00	separately if
Henry Lindon 15,000.00	desired.)
Thomas J.	
Peterson.... 5,000.00	
<u>\$50,000.00</u>	<u>\$50,000.00</u>

INSTALMENT No. 3—40%

(Same form of account as for Instalment No. 2)

MINING CORPORATION

§ 153. Details of Incorporation

To illustrate the opening entries for a mining company, assume that the Copper County Mining Company is to be incorporated under the laws of Michigan with an authorized capital stock of \$50,000, consisting of 2,000 shares of \$25 each. The company is to take over from James R. Cooke and Frank Patterson, a partially developed copper mine located in Copper County, Michigan, and carrying with it 200 acres of mineral land. The incorporators and the amount of stock subscribed for by each as of July 15, 1916, are as follows:

Name	Address	Shares	Amount
James R. Cooke	Detroit, Michigan	900	\$22,500
Frank Patterson	Calumet, "	900	22,500
John H. Jerome	Detroit, "	100	2,500
John H. Wilson	" "	100	2,500

The entire mine property is conveyed to the company by Cooke and Patterson in full payment for their subscriptions, and Jerome pays cash in full for his 100 shares. Wilson pays \$100, but, failing to pay the balance, his stock is declared forfeited. Cooke and Patterson each donate 200 shares of stock to the company, this stock to be sold for the purpose of providing working capital. Of the donated stock, 200 shares are sold at \$15 per share and 100 shares at \$20 a share. All this stock is paid for in cash. The sum of \$2,000 has been paid out for development expenses, and \$1,000 is paid on account of new buildings and construction. The various organization expenses have been paid by the incorporators, who are reimbursed after incorporation.

§ 154. Opening Entries

The books of account must contain a complete record of the business operations of the company. The official books and records to be kept by the secretary must be obtained and duly entered up. Opening entries for the corporation are made, under a slightly different plan from the preceding illustrations, as on July 15, 1916, the date of organization:

July 15, 1916

Unissued Stock.....	\$50,000	
To Capital Stock Authorized.....		\$50,000

The Copper County Mining Company has this day been incorporated with a capital stock of \$50,000, par value of shares \$25 each.
(See minute book, page 4.)

James R. Cooke.....	\$22,500	
Frank Patterson.....	22,500	
John H. Jerome.....	2,500	
John H. Wilson.....	2,500	
To Unissued Stock.....		\$50,000

Subscriptions have been received as follows:

James R. Cooke..... 900 shares
 Frank Patterson..... 900 "
 John H. Jerome..... 100 "
 John H. Wilson..... 100 "

Cash	\$2,600	
To John H. Jerome.....		\$2,500
" John H. Wilson.....		100

For full payment of Jerome's subscription to 100 shares of stock, as per agreement; payment of \$100 on Wilson's stock, balance to be paid in 10 days.

Copper County Mine (or Mine Property, or Real Estate)	\$45,000	
To James R. Cooke.....		\$22,500
" Frank Patterson.....		22,500

The Copper County Mine property and all improvements have this day been conveyed to the Company by Cooke and Patterson in full payment for their subscriptions to stock of the Company, 1,800 shares. By order of the directors. (See minute book, page 5.)

Capital Stock Authorized.....	\$47,500	
To Capital Stock.....		\$47,500
To transfer to Capital Stock account the amount of paid-up capital stock.		

Organization Expenses.....	\$325	
To Cash.....		\$325
To cover various incorporating fees and expenses advanced by incorporators, \$35; charges of attorney, \$150; charges of accountant, \$75; other preliminary expenses, \$65.		

§ 155. Entries for Donated Stock

When the stock is donated to the treasury of the Com

pany, an entry is required debiting Treasury Stock and crediting "Working Capital Donated" or "Donation" account, as follows:

Treasury Stock.....	\$10,000	
To Working Capital Donated.....		\$10,000
For 400 shares of the Company's stock donated by James R. Cooke and Frank Patterson, 200 shares each, to be sold to provide work- ing capital.		

The donated stock is placed in the hands of a trustee, usually one of the officers, appointed either by the donors or by the company. An account with this trustee is opened in the stock book and credited with the 400 shares donated. The stock book accounts of the donors are, of course, debited. The donated certificates are attached to their respective stubs in the stock certificate book and cancelled, but stock certificates need not be made out in the trustee's favor, as that necessitates the making of transfers each time a sale is made. As the stock is sold certificates are made out direct to the purchasers, but the record of issue, both in the stock certificate book and in the stock ledger, will show that the stock has been transferred from "Trustee" account. The following entries—most of them in the cash book—are necessary:

Cash	\$3,000	
To Treasury Stock.....		\$3,000
For the sale of 200 shares of treasury stock at \$15 per share to the following persons: (Names entered here)		

Cash	\$2,000	
To Treasury Stock.....		\$2,000
For sale of 100 shares of treasury stock at \$20 per share to the following persons: (Names here)		

Development Expenses.....	\$2,000	
To Cash.....		\$2,000
Expenditures for developing the surface and entrance to the mine.		
Mine Construction (or Building and Improvements)	\$1,000	
To Cash.....		\$1,000
Expenditures for construction purposes at the mine.		
Working Capital Donated.....	\$2,500	
To Treasury Stock.....		\$2,500
To adjust difference between book price and sale price of the 300 shares of treasury stock already sold.		

§ 156. Entries for Forfeited Subscription

The subscription of John H. Wilson was not completed, and after calling on Wilson for payment of the amount still due on his stock—\$2,400—without result, it was declared forfeited. It is debited back to Unissued Stock as follows:

Unissued Stock.....	\$2,500	
To John H. Wilson.....		\$2,400
" Profit on Forfeited Stock.....		100
For 100 shares of stock subscribed for by John H. Wilson, on which but \$100 was paid and the stock was therefore declared forfeited.		

The entry to be made for forfeited stock must obviously depend on the manner of making the opening entries.

The \$100 paid by Wilson is retained by the corporation and is credited at once to Profit on Forfeited Stock or to Profit and Loss. Before forfeiting stock for unpaid subscriptions, the statutes of the state should be consulted for the procedure required. In the absence of any such provision, the stock may be forfeited when the subscriber, after demand therefor, refuses or is unable to pay the amount due.

Sometimes the forfeited shares are advertised for sale and sold to the highest bidder who in this case must offer at least \$2,400.

The foregoing entries are for a mine with a small capitalization, but the general requirements are the same for any mining company.

There are still on hand 100 shares of treasury stock which may be sold at an early date or held until it will sell for a higher rate or even a premium. In case the mine proves to be successful, there should be no difficulty in disposing of this stock at a higher price. The profit realized from the donation of stock may be transferred from Working Capital Donated account to Surplus if so desired.

CHAPTER XIII

PARTNERSHIPS INCORPORATED

The entries of the present chapter are those required for the amalgamation and incorporation of two Chicago partnerships which for a number of years have been successfully conducting a manufacturing business. The entire business—plant, good-will, assets, and liabilities—of each concern is to be transferred to the new company in exchange for capital stock. Preliminary to this it is necessary to discuss briefly the general nature and treatment of good-will.

§ 157. Good-Will

“Good-will is the monetary value placed upon the connection and reputation of a mercantile or manufacturing concern, and discounts the value of the turnover of a business in consequence of the probabilities of the old customers continuing.”* An eminent English jurist† defines good-will as “every advantage . . . that has been acquired by the old firm in carrying on its business, whether connected with the premises in which the business was previously carried on, or with the name of the late firm, or with any matter carrying with it the benefit of the business.”

Lisle in his “Accounting in Theory and Practice,” gives as the basis of the value of good-will, the place, the name, and the chance that no one connected with the old firm will step in to compete. There are other elements which enter

*George Lisle in “Accounting in Theory and Practice.”

†Vice-Chancellor, Sir W. Page Wood.

in, however; such as the personnel of the concern, its trademarks, etc. Although complex, good-will may be defined in general terms as the value of any benefits a business may enjoy or advantages it may possess, apart from its actual property or other tangible holdings.

§ 158. Determination of the Value of Good-Will

As a rule, the question of computing the value of good-will comes up only when a business is to be sold or its proprietorship transferred. Then arises the necessity of knowing how much must be paid for that element in the business which is represented by the increase in its earning capacity. The business has property of a certain definite value. It also has profit-producing power beyond mere interest and replacement returns on the material value of the capital and property invested. This is the good-will; and the price for which a business is sold will, of course, include this good-will, as will also the capitalization if the business is incorporated.

Good-will is in many cases the most valuable asset of a large business. The Royal Baking Powder Company, when amalgamating with its competitors, is said to have valued the good-will carried by the word "Royal" at \$12,000,000. The annual report of the B. F. Goodrich Company carries the item of "good-will" at \$57,789,000, while real estate, plant, etc., are valued at \$12,679,151, and patents at \$583,650. As the company has outstanding \$60,000,000 common stock and \$30,000,000 preferred, the good-will constitutes over 64% of the value back of the capitalization.

It is customary to base the value of good-will upon the profits of a concern for a given number of years. The average profits for a period of from three to five years previous to the date of valuation are taken, and from these is deducted a fair percentage as interest on the original in-

vestment of the proprietor, and a like deduction is made for his services. The sum that remains is the basis for determining the good-will. A wholesale or retail trading concern may fix the value of its good-will at from one to five years' profits; while in a professional business it is estimated at from one to two years' profits. The value may vary not only with the nature of the business, but also with the particular conditions under which it operates. In a business which has an absolute monopoly in one line, the good-will may well be considered as much larger than in the ordinary business; again, a business which requires the personal attention of but one man is worth more than a business of equal turnover which takes up the entire attention of two or three men.

§ 159. Accounting Treatment of Good-Will

Good-will is commonly regarded as a fixed asset, since it represents a definite capacity for earning. This capacity, although it may vary with business conditions, can never be said to depreciate in the accounting sense. Good-Will account, therefore, unless written off, or increased with the growth of the business, remains the same, showing on the debit side the amount originally paid for the good-will.

Good-Will account in the case of corporations is also used at times as a convenient place in which to record over-capitalization or capitalization in excess of property values. When an incorporating concern has valued its actual property at a certain amount, its good-will is valued at such additional amount as will make the total capitalization of the company equal to the estimated value of the business. Good-will, then, being an elastic quantity, may easily be estimated at more than it is actually worth. Whether estimated conservatively or not, in all such cases the Good-Will account in the ledger shows the difference between the face

value of the capital stock and the value of the actual property owned by the corporation.

There is a tendency in modern business to dispense with good-will altogether, it being written off the books gradually. The General Electric Company and the Victor Talking Machine Company have each written their good-will down to \$1.00 at which amount it is being carried on the books. A possible reason for this is that the valuation of good-will being based on a given number of years' purchase of the profits of the vendor concern, less a fair return on capitalization, its cost is consumed concurrently with the efflux of the period for which it has been purchased. The general practice, however, is to regard the book value of good-will as unchangeable, simply representing the amount paid for it in the first place.

§ 160. Conditions of the Incorporation

In Illinois the entire capital stock must be subscribed and one-half paid up before the company is permitted to begin operations, and therefore the partnership agreements to take stock appear in the application for charter. The actual transfer of the partnership assets and liabilities to the corporation is not, of course, made until the latter is completely organized and ready to enter into contracts. The transfer acts practically as a dissolution of the partnerships.

The change of ownership incident to the transfer of a partnership business to a corporation does not necessarily produce any change in the business or in the established policy of management; or even in the manner of keeping the books of account, except such changes as are necessary to adjust the capital account to the altered conditions. During the process of the incorporation now to be considered, the partnerships go on with their operations as before, all

of the output after the agreed date belonging to the corporation.

§ 161. Agreement for Incorporation

Certain preliminary agreements have been entered into by the owners of the two concerns now being consolidated. The matter of good-will, amount at which to capitalize, proportions of common and preferred stock, the allotment of shares among incorporators, the selection of officers, etc., have all been given careful consideration and are embodied in the preliminary agreement for incorporation which follows:

AGREEMENT FOR INCORPORATION OF

LOWELL, MASON & COMPANY AND OLIVER & DICKSON

This Agreement for Incorporation made this 28th day of August, 1916, by and between Robert Lowell, Walter F. Mason, and Norman Lowell, copartners in the manufacture and sale of chemicals and chemical supplies in the city of Chicago, under the firm name of Lowell, Mason & Company, and Nelson G. Oliver and George Dickson, copartners in the manufacture of chemicals, also in the city of Chicago, under the firm name of Oliver & Dickson.

Witnesseth:

1. That the business heretofore conducted by each of the above-named firms shall be amalgamated and incorporated under the laws of the State of Illinois as the Lowell-Mason Chemical Company.

2. That the capital stock of said corporation shall be Five Million Dollars (\$5,000,000), consisting of Three Million Dollars (\$3,000,000) of common stock, being 30,000 shares of the par value of One Hundred Dollars (\$100) each, and Two Million Dollars (\$2,000,000) of seven per cent (7%) cumulative preferred stock, being 20,000 shares of the par value of One Hundred Dollars (\$100) each. Three Million Dollars (\$3,000,000) of the common stock, being the entire issue thereof, and One Million Dollars (\$1,000,000) of the preferred stock, is to be issued full-paid in exchange for the said businesses as going concerns as hereinafter stated, including all of their assets, credits, trade-names, form-

ulae, and good-will, and said incorporated company shall assume all of the outstanding liabilities of the said firms as existing at the time of transfer, on the date of final organization.

3. That the stock of the said corporation shall be issued full-paid as follows: To the aforesaid firm of Lowell, Mason & Company, One Million, Five Hundred Thousand Dollars (\$1,500,000) of common stock and Five Hundred Thousand Dollars (\$500,000) of preferred stock, distributed to the partners as follows:

Robert Lowell,	7,500	shares	common	and	2,500	shares	preferred
Walter F. Mason,	6,000	"	"	"	2,000	"	"
Norman Lowell,	1,500	"	"	"	500	"	"

To the aforesaid firm of Oliver & Dickson, One Million, Five Hundred Thousand Dollars (\$1,500,000) of common stock and Five Hundred Thousand Dollars (\$500,000) of preferred stock, distributed to the partners as follows:

Nelson G. Oliver,	7,500	shares	common	and	2,500	shares	preferred
George Dickson,	7,500	"	"	"	2,500	"	"

The remaining stock, being One Million Dollars (\$1,000,000) of preferred stock, is to be underwritten by Baker, Wilson & Shaw, bankers, at 95 (5% commission), a contract to that effect having already been executed.

4. And it is covenanted and agreed that Two Hundred Thousand Dollars (\$200,000) of common stock shall be returned by the aforesaid contracting parties to the corporation, One Hundred Thousand Dollars (\$100,000) from each firm, to be treasury stock and to be given to the said bankers free of charge as a bonus with the One Million Dollars (\$1,000,000) of preferred stock subscribed by them.

5. That the Board of Directors shall consist of five members, and the first Board named shall consist of:

Robert Lowell
Walter F. Mason
Norman Lowell
Nelson G. Oliver
George Dickson

That cumulative voting shall be employed in the election of directors; that directors shall be stockholders; and that salaries of officers shall be fixed or changed only by a four-fifths' vote of the entire Board.

6. The first officers of the corporation shall be as follows:

President.....Robert Lowell
 Vice-President.....Nelson G. Oliver
 Treasurer.....Walter F. Mason
 Secretary.....George Dickson

and that the President and Treasurer shall each have an annual salary of Twelve Thousand Dollars (\$12,000), and that the Vice-President and Secretary shall each have an annual salary of Eight Thousand Dollars (\$8,000).

7. That after the formation of said corporation the existing firms of Lowell, Mason & Company and Oliver & Dickson shall be formally dissolved, and the business connections of each, and the general public, shall be formally notified thereof.

IN WITNESS WHEREOF, the parties have hereunto affixed their hands and seals on the day and year first above written.

ROBERT LOWELL	[L. S.]
WALTER F. MASON	[L. S.]
NORMAN LOWELL	[L. S.]
NELSON G. OLIVER	[L. S.]
GEORGE DICKSON	[L. S.]

Attest:

CHARLES W. BENNETT

§ 162. Allotment of Stock

The allotment of common and preferred stock is given in fuller detail in the following tabulation:

Name	Address	Shares		Amount
		Common	Preferred	
Robert Lowell	Chicago	7,500	2,500	\$1,000,000
Walter F. Mason	"	6,000	2,000	800,000
Norman Lowell	"	1,500	500	200,000
Nelson G. Oliver	"	7,500	2,500	1,000,000
George Dickson	Evanston	7,500	2,500	1,000,000
Baker, Wilson & Shaw	Chicago	.....	10,000	1,000,000
Total Subscriptions.....		30,000	20,000	\$5,000,000

§ 163. Underwriting Expenses

It is customary for corporations in disposing of large stock and bond issues, to seek the aid of well-known bank-

ing houses. When this is done, the bankers "underwrite," or become responsible for, the sale of a given amount of stock. In the present instance the amount involved is \$1,000,000, the bankers agreeing to take this entire block of stock at 95, or rather on a 5% commission basis. They then sell the stock to their customers at par or above, the difference between the cost and selling prices representing their profit or commission. It is probable that in a case like this the preferred stock would be sold at par and the \$200,000 of common stock be included therewith as a bonus, the transaction bringing the bankers a profit of \$50,000—the amount of their commission.

To the newly organized company the transaction is legitimate, since the \$50,000 realized by the bankers is regarded as a selling commission, exactly as if the expense of selling the stock had been incurred by the company itself. The bonus of treasury stock given the bankers might be entered on the books, as shown later; or be transferred directly from the stockholders to the banking firm, or to the new purchasers, without being entered on the books at all. As the incorporators have donated the stock for the good of the cause, it matters little how the transaction is handled so long as the desired end is reached, and such receipts or other evidences of it are preserved as will establish the facts should the necessity arise.

When stock is underwritten it is not unusual for the bankers to turn over to the company full payment for the underwritten stock; a check for the difference between this amount and the underwritten price being, in turn, given to them. Such amount is then charged to Commission account or to Underwriting Expense or some other suitable account. This has the merit of bringing the transaction on the books in a very clear and simple manner, and of eliminating from record the appearance of selling stock at a discount. In the

present case, however, but 50% of the underwritten stock (\$500,000) is paid by the underwriters at the time, and a check for \$25,000 (5% commission on 50% of the underwritten stock), is given to them. The remainder of the underwriters' subscription (\$500,000) will be paid later as per agreement.

§ 164. Balance Sheets of the Incorporating Firms

The balance sheets of the two partnerships, Lowell, Mason & Company and Oliver & Dickson, as of September 1, 1916, before the incorporation, are given below. These statements and the agreement for incorporation as given in § 161, form the basis for opening the books of the new company.

LOWELL, MASON & COMPANY BALANCE SHEET, SEPTEMBER 1, 1916

<i>Assets</i>	<i>Liabilities</i>
Land and Buildings... \$250,000.00	Mortgage Payable.... \$100,000.00
Machinery and Tools. 115,000.00	Interest Accrued..... 2,500.00
Patents and Patterns.. 72,800.00	Notes Payable..... 40,000.00
Trucks and Motors... 25,000.00	Interest Accrued..... 1,500.00
Fuel and Supplies.... 12,400.00	Accounts Payable.... 25,000.00
Raw Material..... 52,800.00	Accrued Taxes..... 6,500.00
Work in Process..... 57,300.00	Reserve Accounts:
Finished Stock..... 44,900.00	For Depreciation... 12,000.00
Deferred Charges to	" Bad Debts..... 2,200.00
Operating 9,250.00	Capital Accounts:
Investments in Stocks	Robert Low-
and Bonds..... 143,700.00	ell .....\$500,000
Notes Receivable..... 142,000.00	Walter F.
Accounts Receivable.. 174,800.00	Mason ... 400,000
Cash 95,000.00	N o r m a n
	Lowell .. 100,000 1,000,000.00
	Profits Undivided.... 5,250.00
<u>\$1,194,950.00</u>	<u>\$1,194,950.00</u>

OLIVER & DICKSON
BALANCE SHEET, SEPTEMBER 1, 1916

<i>Assets</i>		<i>Liabilities</i>	
Leasehold	\$156,000.00	Notes Payable (Secured)	\$126,000.00
Machinery and Tools..	85,000.00	Accounts Payable.....	136,300.00
Delivery Equipment..	30,000.00	Interest Accrued.....	1,600.00
Fuel and Supplies....	9,400.00	Accrued Operating Charges	10,700.00
Patents and Patterns..	122,000.00	Capital Accounts:	
Raw Material.....	75,100.00	Nelson G.	
Work in Process.....	80,900.00	Oliver ...	\$500,000
Finished Stock.....	198,000.00	George	
Deferred Charges....	12,300.00	Dickson..	500,000 1,000,000.00
Bonds and Securities.	150,000.00		
Accounts Receivable,			
Net (book value			
\$223,000).....	221,500.00		
Cash	134,400.00		
	<u>\$1,274,600.00</u>		<u>\$1,274,600.00</u>

§ 165. Statutory Requirements

The Illinois statutes state that, "It shall be the duty of the directors or trustees of every stock corporation to cause to be kept at its principal office or place of business in this state correct books of account of all its business, and every stockholder in such corporation shall have the right at all reasonable times, by himself or by his attorney, of examining the records and books of account of the corporation."

§ 166. Opening Entries

The opening entries for the new corporation must be such as will record correctly and in proper sequence the various transactions involved in the incorporation of the company, and in transferring to it, in exchange for its capital stock, the entire plant, business, and net assets of each firm. Those shown below do not differ materially from the entries

given in previous chapters, except in the manner of making charges for stock. Instead of opening accounts for the various subscribers or even for subscriptions, accounts are opened separately for the three different concerns which have subscribed for stock, and the amount agreed upon is charged to each.

September 1, 1916

First Entry

Unissued Common Stock.....	\$3,000,000	
Unissued Preferred Stock.....	2,000,000	
To Capital Stock—Common		\$3,000,000
" Capital Stock—Preferred		2,000,000

The Lowell-Mason Chemical Company is incorporated this day under the laws of Illinois, with a capital stock of \$5,000,000 divided into 30,000 shares of common stock of the par value of \$100 each, and 20,000 shares of 7% cumulative preferred stock of the par value of \$100 each.

In the second entry, each firm is charged with the amount of stock to be turned over to its members, or to whomsoever it directs. A separate entry and explanation might be made, if desired, for each firm, or even for each subscriber, but in either case each entry should clearly state the amount of common and preferred stock taken. The entry for stock given to the banking firm might advantageously be separated from the others.

Second Entry

Lowell, Mason & Company.....	\$2,000,000	
Oliver & Dickson.....	2,000,000	
Baker, Wilson & Shaw.....	1,000,000	
To Unissued Common Stock.....		\$3,000,000
" Unissued Preferred Stock.....		2,000,000

Subscriptions of the above firms for the entire common and preferred stock of the Company; the distribution of this stock, as per agreement for incorporation, the subscription list, and the certificate of incorporation, being as follows:

Name	Shares	
	Com- mon	Pre- ferred
Robert Lowell.....	7,500	2,500
Walter F. Mason....	6,000	2,000
Norman Lowell....	1,500	500
Nelson G. Oliver....	7,500	2,500
George Dickson....	7,500	2,500
Baker, Wilson & Shaw		10,000
Total.....	30,000	20,000

September 1, 1916

Third Entry

Plant and Sundry Assets.....	\$2,000,000	
To Lowell, Mason & Company.....		\$2,000,000
Purchase price of the plant, assets, and business of Lowell, Mason & Company taken over this day as a going concern, in full payment of stock subscriptions to 15,000 shares of common and 5,000 shares of preferred stock of the Company, as per agreement for incorporation. (See minute book, page 5.) All right, title, and interest in the assets of Lowell, Mason & Company are conveyed to the Lowell-Mason Chemical Company, and all liabilities of that firm are assumed by the Lowell-Mason Chemical Company, as per agreement for incorporation.		

Fourth Entry

Sundries to Sundries:

Land and Buildings.....	\$250,000	
Machinery and Tools.....	115,000	
Patents and Patterns.....	72,800	
Trucks and Motors.....	25,000	
Fuel and Supplies.....	12,400	
Raw Material.....	52,800	
Work in Process.....	57,300	
Finished Stock.....	44,900	
Deferred Charges to Operating.....	9,250	
Investments in Stocks and Bonds.....	143,700	
Notes Receivable.....	142,000	
Accounts Receivable.....	174,800	
Cash	95,000	
Good-Will	1,000,000	
To Mortgage Payable.....		\$100,000
" Interest Accrued.....		4,000
" Notes Payable.....		40,000
" Accounts Payable.....		25,000
" Accrued Taxes.....		6,500
" Reserve for Depreciation.....		12,000
" Reserve for Bad Debts.....		2,200
" Surplus		5,250
" Plant and Sundry Assets.....		2,000,000

To record in the ledger the various specific assets and liabilities turned over by Lowell, Mason & Company.

Fifth Entry

Plant and Sundry Assets.....	\$2,000,000	
To Oliver & Dickson.....		\$2,000,000
Purchase price of the plant, assets, and business of Oliver & Dickson, taken over by the Company as a going concern, as per agreement for incorporation. (See minute book, page 5.)		
Assets of Oliver & Dickson are taken over and liabilities assumed by Company as shown below.		

Sixth Entry

Sundries to Sundries:

Leasehold	\$156,000	
Machinery and Tools.....	85,000	
Delivery Equipment.....	30,000	
Fuel and Supplies.....	9,400	
Patents and Patterns.....	122,000	
Raw Material.....	75,100	
Work in Process.....	80,900	
Finished Stock.....	198,000	
Deferred Charges.....	12,300	
Bonds and Securities.....	150,000	
Accounts Receivable.....	223,000	
Cash	134,400	
Good-Will	1,000,000	
To Notes Payable (Secured).....		\$126,000
" Accounts Payable.....		136,300
" Interest Accrued.....		1,600
" Reserve for Bad Debts.....		1,500
" Accrued Operating Charges.....		10,700
" Plant and Sundry Assets.....		2,000,000

To record in the ledger accounts the specific assets and liabilities turned over by Oliver & Dickson, as above.

Seventh Entry

Cash	\$500,000	
To Baker, Wilson & Shaw.....		\$500,000
Payment of 50% of subscription of Baker, Wilson & Shaw, underwriters, to \$1,000,000 of preferred stock.		

Eighth Entry

Organization Expense.....	\$31,000	
To Cash.....		\$31,000
By order of the directors for payment of various expenses incurred during the incorporation of the Company, including 5% commission to Baker, Wilson & Shaw on \$500,000 of stock subscription. (Give expense items in detail.)		

Ninth Entry

Treasury Stock—Common.....	\$200,000	
To Stock Donation Account.....		\$200,000
2,000 shares of common stock donated to the Company in accordance with the agreement for incorporation, as follows:		
Lowell, Mason & Company 1,000 shares		
Oliver & Dickson..... 1,000 “		

Tenth Entry

Stock Donation Account.....	\$200,000	
To Treasury Stock—Common.....		\$200,000
For the bonus of 2,000 shares of common stock transferred to Baker, Wilson & Shaw as per underwriting contract, being one share of common stock for every five of preferred stock underwritten. This stock has been donated by the incorporators and is full-paid and non-assessable.		

\$500,000 of the underwriters' stock subscription still remains to be settled for as per agreement, at which time Cash and Organization Expense will be increased and the account with Baker, Wilson & Shaw closed out.

§ 167. Closing the Partnership Books

The manner of closing the partnership books will be illustrated in detail by the closing entries for Lowell, Mason & Company. A somewhat different procedure is shown in condensed form in closing the books of Oliver & Dickson.

It is not unusual, when a partnership is incorporated, for the bookkeeping system, if well-arranged, to be retained and be used by the new company, rather than to open new books. When that is the case, only such entries are required as are necessary to open the accounts peculiar to the corpora-

tion and record the transactions incident to incorporation. However, in the case now under consideration new books are presumed to have been opened, and, of course, all asset and liability accounts must necessarily be closed on the partnership books and the balances be transferred to the corporation's accounts.

It will be noticed that each firm has been allowed \$1,000,000 for its good-will in addition to payment in full for its net worth. The amount may be too much, but that is a matter with which the accountant is not particularly concerned since this has already been determined and he must accept conditions as he finds them. The two firms receive stock of the new company in exchange for their respective plants and net assets; and this stock in turn is apportioned to the former partners in proportion to their holdings as set forth in the agreement. The successive entries shown below exhibit in proper sequence the procedure and book entries required.

§ 168. Closing Entries on Books of Lowell, Mason & Company

The following entries will properly adjust and close the accounts of Lowell, Mason & Company. The same end could be reached by different series of adjusting entries.

First Entry

September 1, 1916

Good-Will	\$1,000,000	
To Robert Lowell.....		\$500,000
' Walter F. Mason.....		400,000
" Norman Lowell.....		100,000
To place upon the books good-will of		
\$1,000,000 in accordance with agree-		
ment for incorporation of the Lowell-		
Mason Chemical Company entered into		
August 28, 1916. Good-will appor-		
tioned according to the partners' hold-		
ings.		

Second Entry

Lowell-Mason Chemical Company..... \$2,194,950

To Sundry Assets:

Land and Buildings.....	\$250,000
Machinery and Tools.....	115,000
Patents and Patterns.....	72,800
Trucks and Motors.....	25,000
Fuel and Supplies.....	12,400
Raw Material.....	52,800
Work in Process.....	57,300
Finished Stock.....	44,900
Deferred Charges to Operating...	9,250
Investments in Stocks and Bonds.	143,700
Notes Receivable.....	142,000
Accounts Receivable.....	174,800
Cash	95,000
Good-Will	1,000,000

Plant, good-will, and sundry assets turned over to the Lowell-Mason Chemical Company in exchange for \$2,000,000 par value of stock of that Company, as per agreement for incorporation.

Third Entry

Sundry Liabilities:

Mortgage Payable.....	\$100,000
Notes Payable.....	40,000
Interest Accrued.....	4,000
Accounts Payable.....	25,000
Accrued Taxes.....	6,500
Reserve for Depreciation.....	12,000
Reserve for Bad Debts.....	2,200
Profits Undivided.....	5,250

To Lowell-Mason Chemical Company \$194,950
 To close accounts and transfer to Lowell-Mason Chemical Company all of the liabilities of this firm, as per agreement for incorporation.

All assets and liabilities have now been closed off and

transferred to the new corporation; and the only accounts remaining open are the capital accounts of partners and the debit balance of the Lowell-Mason Chemical Company. The required amount of stock has been received from the new company to pay for the \$2,000,000 of net assets turned over. This stock is distributed to the former partners as originally agreed, and entered on the books as follows:

Stock of Lowell-Mason Chemical Company \$2,000,000

To Lowell-Mason Chemical Company \$2,000,000
 For 20,000 shares of stock of Lowell-Mason Chemical Company received to-day in full payment for net assets shown in the previous entries. The stock is issued in the partners' names as follows:

Names	Shares		Par Value
	Com- mon	Pre- ferred	
Robert Lowell..	7,500	2,500	\$1,000,000
Walter F. Mason	6,000	2,000	800,000
Norman Lowell	1,500	500	200,000
Total.....	15,000	5,000	\$2,000,000

Robert Lowell.....	\$1,000,000
Walter F. Mason.....	800,000
Norman Lowell.....	200,000

To Stock of Lowell-Mason Chemical Company \$2,000,000
 For distribution of the above-mentioned stock to the partners, and to close the capital accounts of the firm.

§ 169. Closing the Books of Oliver & Dickson

The entries below illustrate another plan of closing the partnership accounts. These entries are condensed as much as possible so as to show merely the procedure rather than

the record of details such as was shown in the previous closing entries.

Good-Will	\$1,000,000	
To Nelson G. Oliver.....		\$500,000
" George Dickson.....		500,000
(Full explanation here.)		

Lowell-Mason Chemical Company.....	\$2,000,000	
Sundry Liabilities (listed separately).....	274,600	
To Good-Will and Sundry Assets		
(listed separately).....		\$2,274,600
(Full explanation here for transfer of all assets and liabilities.)		

Nelson G. Oliver.....	\$1,000,000	
George Dickson.....	1,000,000	
To Lowell-Mason Chemical Company		\$2,000,000
To close capital accounts of the partners upon distribution to them of stock of the Lowell-Mason Chemical Company:		

Shares

Name	Common	Preferred
Nelson G. Oliver..	7,500	2,500
George Dickson.,.	7,500	2,500
Total.....	15,000	5,000

§ 170. Balance Sheet of New Company

The accompanying balance sheet of the new corporation shows the combined assets and liabilities and capital stock of the Lowell-Mason Chemical Company. The balance sheet of each firm as given in § 164 shows the condition of the two firms at the time of the incorporation. Add \$1,000,000 for good-will to the net capital of each firm to get the value placed upon its business. On the books of the new company the assets and liabilities taken over from the two firms are,

of course, to be combined in the respective accounts, as shown in the consolidated balance sheet herewith.

Sometimes, the names of accounts are changed slightly to meet the tastes of the accountant or bookkeeper; and it might be advisable to keep the two sets of accounts with customers of the respective firms in separate ledgers. The good-will of \$2,000,000 might have been reduced to \$1,994,750 and the surplus of \$5,250 eliminated. The organization expenses are usually spread over a term of five or ten years by annual charges to Profit and Loss.

LOWELL-MASON CHEMICAL COMPANY
BALANCE SHEET AS ON SEPTEMBER 1, 1916

<i>Assets</i>		<i>Liabilities</i>	
Land and Buildings...	\$250,000.00	Mortgage Payable....	\$100,000.00
Machinery and Tools.	200,000.00	Notes Payable.....	166,000.00
Patents and Patterns..	194,800.00	Accounts Payable....	161,300.00
Leasehold	156,000.00	Interest Accrued.....	5,600.00
Trucks and Motors...	25,000.00	Accrued Taxes and	
Delivery Equipment..	30,000.00	Charges	17,200.00
Fuel and Supplies....	21,800.00	Reserve Accounts:	
Raw Material.....	127,900.00	For Depreciation...	12,000.00
Work in Process.....	138,200.00	“ Bad Debts.....	3,700.00
Finished Stock.....	242,900.00		
Deferred Charges to		Total Liabilities	\$465,800.00
Operating	21,550.00		
Investments	293,700.00	Capital Stock:	
Notes Receivable....	142,000.00	Common	3,000,000.00
Accounts Receivable..	397,800.00	Preferred, 7% Cum-	
Cash	698,400.00	ulative	2,000,000.00
Subscriptions to Stock	500,000.00	Surplus	5,250.00
Organization Expenses	31,000.00		
Good-Will	2,000,000.00		
	<u>\$5,471,050.00</u>		<u>\$5,471,050.00</u>

Part IV—Corporate Bond Issues

CHAPTER XIV

THE CORPORATION BOND

§ 171. Nature of the Bond

A bond is a promise under seal to pay a definite sum of money at a stated time, usually with an agreement to pay interest at certain periods, and a pledge of certain properties as security for payment of both principal and interest. When a corporation borrows money, its indebtedness may be evidenced either by notes or bonds. If the amount borrowed is small, or if it is borrowed in a single sum, or but from few persons, or for a short time, notes are usually given. If, however, the amount is large and obtained from a number of people, and borrowed for a period of years, the corporate obligation is preferably and usually evidenced by bonds.

The difference between a corporate note and a bond is not always clearly marked. Both are promises to pay money. The phrasing of the bond is usually more formal than that of the note, and it must be executed under seal, while the corporate note need not. Also payment of bonds is usually, though not invariably, secured as to both principal and interest by certain specified property held for the purpose under a formal deed of trust.

A bond payable "to order," or "to bearer," or "to holder," is a negotiable instrument, and this in spite of the

fact that it is executed under seal. Hence, if such a bond is in due form and is purchased for value and in good faith, the purchaser is protected against any defenses set up by the corporation and against any claims of previous owners.

A bond issue consists of a number of bonds which, while they may vary as to denomination, are all of like general tenor, and, if secured at all, are all secured and, unless otherwise expressly provided, equally secured under one deed of trust.

Bonds are issued in varying denominations. \$1,000 is the usual face value; \$500 bonds are not infrequently issued; \$100 bonds have grown in favor in the past few years; and bonds are sometimes issued for popular subscription of still smaller face value. Bonds of a face value of \$5,000 and \$10,000 are frequent, and they are sometimes issued in still larger denominations.

Bonds are a direct corporate obligation and do not in any way partake of the nature of stock. They may, however, be given rights of participation in corporate profits if desired, and, in the absence of statutory prohibition, may be given voting rights as well.

§ 172. Authorization of Bond Issues

"The power of a corporation to borrow money is implied, and exists without being expressly granted by a charter or statute."* In the absence of restraining laws, a corporation may therefore issue corporate notes and bonds to any desired amount. Also, unless otherwise expressly provided by law, or by charter or by-law provision, the power to incur corporate indebtedness lies with the directors, and they may at their discretion issue corporate notes and bonds without authorization from the stockholders. Public utility corporations operating under the jurisdiction of

* Cook on Corporations, § 760.

states having a public utility commission are usually required to secure the authorization of the commission for any contemplated bond issues.

§ 173. Constitutional and Statutory Provisions Affecting Bond Issues

Constitutional provisions affecting the issue of bonds are found in many states, but as a rule confine themselves to the requirement that bonds shall be issued only for value and that any fictitious increase of indebtedness is void. In a few states the constitution requires the authorization of bond issues by stockholders.

Statutory provisions requiring the assent of a specified majority of the stockholders before bonds may be issued are also found in many states. The statutory provisions also frequently specify the notice which must be given for stockholders' meetings to authorize bond issues.

Statutory provisions limiting the amount of corporate indebtedness are found in many states, and in some states specific provisions exist as to the selling price of bonds, as in North Carolina where the statutes provide that bonds may be sold below par and commissions may be paid upon the sales. Other special provisions as to bond issues are found in a number of states.

The statutes of the particular state should, of course, always be consulted when a bond issue is contemplated. Any proposed action may be materially affected by the provision of the law.

§ 174. Procedure in Issuing Bonds

The various steps to be taken in any bond issue must necessarily depend upon the kind of bonds and the conditions of the particular issue. The general procedure is about as follows, subject to any statutory, charter, or by-

law provisions which may apply. It will be understood, of course, that any important bond issue should be made under the direct supervision of competent attorneys.

1. The directors pass a preliminary resolution recommending the bond issue and directing the call of a special meeting of stockholders to consider the recommendation. Even where the directors have power to authorize a bond issue, it seems preferable and prudent to obtain the approval of the stockholders.

2. A statement of the proposed bond issue is then prepared and submitted for the consideration of the stockholders. This should give the time to run, how secured, terms of payment, rate of interest, redemption conditions, and all other important details.

3. If the bond issue is approved by the stockholders, their approval is usually expressed in the form of a resolution, though sometimes when a meeting is inadvisable, the issue is approved by written consent of the individual stockholders.

4. The issue having been sanctioned by the stockholders, the directors pass such resolutions as are necessary to authorize the bonds and their issue in due form by the officers of the corporation.

5. If there is a public service commission in the state, proposed bond issues of all corporations coming under its jurisdiction must have its approval before issuance.

6. A trust company is usually selected as the trustee for the bonds, and a contract is made for its services.

7. The deed of trust conveying properties to the trustee in trust for bondholders, and setting forth all the conditions under which the bonds are issued, is drawn and duly executed by the proper officers of the company.

8. The bonds are prepared. These are usually engraved on a good bond paper with coupons attached if the issue

is of coupon bonds. The trustee's certificate must appear on each bond.

9. If realty is covered by the deed of trust, a copy must be filed in every county where the real estate is located.

10. Sale of bonds either direct to the public, or through some firm of bankers, is provided for. This is usually done either before the bonds are authorized or soon after. The sale price usually depends on the standing of the issuing company.

11. Provision must be made for the payment of interest coupons at the issuing office or by some bank or trust company.

12. Provision must be made for the redemption of bonds at the date provided by the trust agreement.

§ 175. Preparation of Bonds

Bonds are usually printed or engraved by a responsible company and from specially prepared plates. Every precaution is taken to prevent the plates or any impression from them being lost or stolen, and the engravers may even be required to give security against loss resulting from negligence on their part. The bonds are bound in book form and numbered consecutively or in series. When ready for issue the bonds are sealed with the corporate seal, attested by the officers of the issuing company, and then sent to the trustee, who certifies and delivers them as provided in the mortgage. Before certification, each bond is examined to see whether it is in proper form. If all the bonds of an issue are not to be sold at once, the entire issue may be engraved and the reserved bonds held till their time for sale, or the preparation of these latter may be delayed until they are needed. If they will not be used for a number of years, it is preferable to wait until the time of sale to engrave the bonds.

§ 176. Terms Used in Connection with Bonds

Like capital stock, the bond issue is usually authorized for a stated amount, and the bonds are then sold at such times and in such amounts as the conditions dictate. All bonds of the same issue usually bear the same date regardless of the date of sale, and any coupons which have matured before the particular bonds are sold, are clipped off, cancelled, and pasted in the coupon register.

The term "authorized" used in connection with a bond issue, has reference to the aggregate amount of bonds sanctioned or agreed upon by the stockholders and directors, regardless of whether all these are, or are not, disposed of at one time. "Issued" or "outstanding" bonds are those that have actually been disposed of by the company either to the public or to the underwriters. Bonds are "nominally outstanding" when certified by the trustee and offered for sale to the public, or when they are pledged as security or otherwise placed in some fund for the issuing company, no actual sale having taken place. "Unissued bonds" are those that have been authorized but not sold. "Escrow bonds" are those held under option or subject to some other similar condition. "Unsubscribed bonds" include all bonds not yet taken by the public; and "subscribed bonds" those that have been sold or contracted for, though payment for these may not yet have been fully made.

"Treasury bonds" (as the term is ordinarily used) are the unissued or unsubscribed bonds that have not been disposed of by the company. The entire amount of authorized bonds, or any part thereof, may under this interpretation be considered as "treasury bonds" until disposed of by the issuing company. Some accountants, however, prefer to give the term the same meaning as when employed in connection with stock, designating as "treasury bonds" only such bonds of the company as have come back into its

possession by purchase or otherwise, for investment or for sinking fund purposes. Since the term is confusing, it would seem better not to use it at all, but instead to use some term which would clearly and unmistakably indicate the real nature of the account or classification.

Bonds repurchased by the company should be clearly indicated in the balance sheet, either as a subdivision of "Investments," or as "Treasury Bonds," with a suitable explanation of what is meant thereby, or under such other caption as will clearly indicate the nature of the asset without possibility of misunderstanding. Bonds of the company purchased by the trustees of the sinking fund, insurance fund, reserve fund, beneficial fund, or by any subsidiary or affiliated organization, board, or society, should, however, be listed in the assets of such funds, and not necessarily as treasury bonds. Indeed, it is not uncommon for bonds so purchased to be included among the general investments of the company; but this should not be done unless they are distinctly earmarked.

"Cancelled bonds" are those that have, under the terms of the issue, been redeemed by the issuing company through the sinking fund trustee or by direct purchase in the open market. Securities or other properties are said to be in the "treasury" of a company when they are in the custody of the treasurer, who is the financial officer and custodian of all funds and securities. The "bonded indebtedness" of a company has reference to its outstanding bonds. "Funded debt" is another term for "bonded debt" or outstanding bonds, being obligations of a permanent nature the security for which is composed of pledged property.

§ 177. Issued and Outstanding Bonds

The following paragraph taken from the accounting classification of the Interstate Commerce Commission indi-

cates its designations of bonds before and after the issue thereof:

"For the purposes of the balance sheet statement, funded debt securities are considered to be *nominally issued* when certified by trustees and placed with the proper officer for sale and delivery, or pledged, or otherwise placed in some special fund of the accounting company. They are considered to be *actually issued* when they have been sold to a *bona fide* purchaser for a valuable consideration, and such purchaser holds them free from all control by the accounting company. All funded debt securities actually issued and not reacquired and held by or for the accounting company are considered to be *actually outstanding*. If reacquired by or for the accounting company under such circumstances as require them to be considered as held alive and not cancelled or retired, they are considered to be *nominally outstanding*."

The term "treasury bond" is not used in the Commission's classification. It is understood by the Commission, however, to cover either nominally issued or nominally outstanding bonds which are held by the corporation in its treasury upon its own behalf. It may be said that this is the stand taken by public utility commissions also, but the accountant or corporation official may freely use whatever caption for accounts he may desire, so long as it is one that is clearly understood by all concerned and the corporation is not subject to commission regulations.

§ 178. Sinking Funds

A sinking fund as applied to bond issues is a fund created for the purpose of redeeming the bonds when due, or prior thereto, as may be provided by the deed of trust. Thus, bonds may be retired from time to time as the sinking fund accumulates, or the fund may be allowed to remain

intact until the maturity of the bonds, when, if properly constituted and maintained, it is sufficient for the retirement of the entire issue.*

§ 179. Sale of Bonds

Unless prevented by statutory enactment, bonds may be sold at any price that can be obtained. In most of the states there are provisions that bonds may be issued only for value actually received, but, in the absence of some more specific limitations, bonds may still be issued below par if in good faith. In some few states more specific provisions exist.

The sale of bonds below par by the issuing corporation might, however, constitute an infraction of the laws against usury. Thus, if a 5% bond of the face value of \$1,000 be sold for \$500, the rate of interest paid on the money so secured is 10%. If, then, this exceeds the legal rate of interest in the state in which the sale was made, the transaction is usurious and illegal, and for this reason the original purchaser, or a subsequent purchaser knowing the circumstances, might be unable to enforce the payment of his bond. This condition could not, however, obtain if the bonds were in the hands of an innocent holder for value, nor in states in which the statutes are silent as to usury, nor in states where bonds may by statute provision be sold below par, nor in states where corporations are not allowed to avail themselves of the defense of usury.

§ 180. Liabilities of Vendor

The vendor of a bond does not warrant the legality of the issue, nor in any way guarantee payment of the bond. All he undertakes is that so far as he has knowledge, the bond is legally issued and what it purports to be, that it

*See also Chapters XX. XXI. "Sinking Funds."

has come into his hands in due course and for valuable consideration, and that he is legally competent to transfer it to the purchaser. In this the bond differs from a note, draft, or check, which the vendor is held to guarantee unless assigned "without recourse."

§ 181. Rights of Holders

A bond as a negotiable or quasi-negotiable instrument is not subject to the defenses that might exist between the original parties. In practice, "the courts go very far in protecting *bona fide* holders of corporation bonds, and will uphold and enforce such bonds under nearly all circumstances. The defense that the bonds were issued below par does not avail as against *bona fide* holders."*

A first mortgage bond does not lose its priority though issued after a second mortgage bond. Nor does the number or date of issue of a bond in any way affect its rights of payment as regards the other bonds of the same issue, unless expressly so provided by the bond or deed of trust. Such provisions are legal but unusual, and, as a rule, every bond of an issue has all the rights of any other bond of that issue.

Bonds cannot be redeemed by the issuing corporation before they are due save by consent of the holders, unless there is express provision in the deed of trust for such prior redemption. Nor can the corporation deposit with the trustee sufficient money for the redemption of the bonds and thereupon cancel the mortgage. It may, of course, deposit the money for the payment of the bonds, but the deed of trust remains in force, and should the deposited money be lost before the bonds mature, the corporation must again provide for their payment if the trustee cannot make good the loss. If, however, at the maturity of the

*Cook on Corporations, § 766; see also *Dickermann v. Northern Trust Company*, 176 U. S. 188 (1900).

bonds, all are not presented for payment, the trustee may reserve a sufficient amount of money for the retirement of the missing bonds and discharge the deed of trust.

Coupons may be detached from their bonds before maturity and be sold separately if the bond is negotiable, but otherwise not. The holder of a negotiable bond or a negotiable coupon, i.e., one payable to bearer or holder or order, is always presumed to be the *bona fide* holder of such bond or coupon until the contrary is proved, and, in the absence of any suspicious circumstances, the corporation may safely take up the instrument and pay the amount due thereon to the holder. Nor, having done so, could it thereafter be held liable, even should it be shown that the holder was not the rightful owner of the bond or coupon.

The pledgee of registered bonds may have them transferred to his own name and may collect the interest or coupons on the pledged bonds as the same become due, but must apply all money so received against the debt.

Suit may be brought on a bond or coupon if not paid at maturity, just as suit may be brought on a promissory note, and this even though the mortgage is not foreclosed. In case of judgment, however, no execution may be had against the mortgaged property. In some few states, as in New Jersey, such suit by the individual holders before foreclosure is forbidden by statute.

In case of foreclosure, if the property held under the deed of trust is not sufficient to pay the bonds secured thereby, the bondholders have recourse against the corporation for the balance due.

CHAPTER XV

CLASSIFICATION OF BONDS

§ 182. General Classification

Bonds may be roughly classified as to the nature of their security, into debenture and mortgage bonds, and as to form, into coupon and registered bonds. The distinguishing features of these general classes are given below.

§ 183. Debentures

Bonds may either be secured or unsecured as to repayment. If unsecured, the bonds are usually termed "debentures." This use of the term is not, however, invariable, as bonds of a certain class secured by collateral are at times similarly designated.

The usual unsecured debenture bond is merely the formal corporate promise to pay money. It is an obligation of the **corporation and** may be sued upon if unpaid at maturity, but, as it is unsecured, there can be no foreclosure in case of default, either as to interest or principal. Its claim is superior to that of preferred stock, but is inferior to that of any secured indebtedness of the corporation. It takes no precedence over any other unsecured debt, and its value therefore depends entirely upon the financial strength of the issuing corporation.

The term debenture bond is also used to designate another type of unsecured bond distinguished by the fact that its interest is not payable unless earned. This interest may be either cumulative or non-cumulative. Such a bond differs from preferred stock only in the fixed obliga-

tion as to its principal; this obligation, however, becomes effective only at the maturity of the bond, no foreclosure or other action being possible before that date.

As stated, secured bonds of a certain class are sometimes styled debentures. To secure payment of these bonds, certain of the corporate assets—usually stocks and bonds of other corporations—are deposited with a trustee under a trust agreement. The bond is then in effect a collateral note, and is frequently called a “collateral trust bond” (§ 196).

§ 184. Mortgage Bonds

A mortgage bond is one the payment of which is secured by a mortgage or deed of trust on part or all of the property of the corporation. This deed of trust usually authorizes the trustees, in case of default on interest or principal of the secured bonds, to take possession of the property and either operate it or sell it, as may be provided, for the benefit of the bondholders.

“Mortgage” bonds are first mortgage, second mortgage, etc., according to the lien of the deed of trust by which they are secured. Thus, a first mortgage bond, as its name implies, is a first lien on the property covered by the deed of trust—unless a builder’s lien, receiver’s certificates, or similar obligations take precedence—while a second mortgage bond secured on the same property is a second lien; i.e., in case of foreclosure the first mortgage bonds must be paid in full, both principal and interest, before the holders of the second mortgage bonds receive anything. First mortgage bonds are therefore obviously more desirable than those of a junior lien, that is, those of an inferior or later lien, unless the property is of such value as to be an absolute and unquestionable security for the entire amount of outstanding bonds.

§ 185. Coupon Bonds

A coupon bond is one which has attached to its coupons, or orders for payment of interest, each coupon requiring payment on its due date of the interest instalment represented by that particular coupon. Coupons are in effect promissory notes, each calling for the payment of one instalment of interest on the bond to which it is attached. The interest on coupon bonds is payable to the holder of its coupons and not to the holder or owner of the bond, unless he is also the owner or holder of the coupons.

Interest on bonds is usually payable semiannually, and each of the coupons attached to a coupon bond calls for the exact amount of one of the semiannual interest payments on that bond. Thus, a coupon bond running ten years with interest payable semiannually, has attached to it twenty coupons. Each coupon is numbered to correspond with its bond, but also has a serial number of its own—running from one to twenty in the instance cited—indicating the order in which the coupons come due. (See § 205; also Chapter XVIII.)

Coupon bonds are usually made payable to bearer, and the coupons of such bonds, regardless of whether the bonds are registered or otherwise, are always payable to bearer and pass by delivery when they are clipped from the bond.

§ 186. Registered Bonds

A registered bond is one issued in the name of some particular person in the same manner as is a certificate of stock, the bond thereafter being transferable only on the books of the company.

Coupon bonds, as stated above, are usually payable to bearer and are then transferable by mere delivery. Sometimes, however, they are issued in registered form as to

principal, or with the option of registry as to principal, as in the case of the United States Steel Corporation bond shown in § 204; but in any such case the coupons are still made payable to bearer. The interest then is paid to anyone who presents the coupon, but the principal—the bond being registered—will only be paid to the person in whose name the bond stands on the books of the company, or to his assignee.

Bonds without coupons are always registered, are transferable only by assignment, and interest is payable to the registered owner alone and is usually paid by checks sent out to these registered owners.

Coupon bonds payable to bearer and registered bonds are often issued under the same deed of trust. Usually, when this is done the two classes of bonds are made interchangeable, i.e., any holder of a coupon bond payable to bearer may at any time exchange it for a registered bond, or the owner of a registered bond may at any time exchange it for a coupon bond payable to bearer.

The advantage of an unregistered coupon bond is found in the readiness with which it may be transferred. The advantage of a registered bond lies in the difficulty of its negotiation in case the bond is lost or stolen. If a bond payable to bearer is either lost or stolen, its sale or disposal is comparatively easy, since, once in the hands of an innocent holder for value, it is valid. A registered bond, on the contrary, should it be lost or stolen, is practically non-negotiable. It is payable only to the party named in the bond, and, before it can be successfully negotiated, the requisite forgery of his signature would effectually prevent a valid transfer.

When registered bonds are assigned, the assignee surrenders the old bond and receives in exchange a bond issued in his own name, the new ownership being recorded

upon the books of the company at the same time. A small fee is usually charged for the transfer or reissue of a bond.

§ 187. **Kinds of Bonds**

Many kinds of bonds are issued, under varying designations, usually derived from the more important or distinctive features of the particular issue.

Bonds frequently possess the characteristics of several different classes. Thus the bonds of the United States Steel Corporation shown in the coupon form in the following chapter, known as "ten-sixty-year five per cent sinking fund gold coupon bonds," were made redeemable at any time after ten years from date of issue at the option of the corporation; their payment is provided for by a sinking fund and they are payable in gold coin. Also, if not previously redeemed, they must be paid at the end of sixty years, and they bear 5% annual interest. All this is indicated by their title.

The bonds most frequently issued are briefly discussed in the following sections.

§ 188. **First Mortgage, etc., Bonds**

A first mortgage bond is one secured on property upon which no other bonds or similar obligations are secured.

If a number of bond issues are secured by the same property, the first issue is, as stated (§ 184), a first mortgage bond; the next, a second mortgage bond; the next, a third mortgage bond, etc.; the lien of each of these latter being inferior to that of the issue or issues which precede it, but superior to that of the issue or issues which follow.

§ 189. **Junior Lien, etc., Bonds**

A junior lien bond is one which comes after, or is in-

ferior to, some other bond or bonds in its lien upon the property by which it is secured. Thus, the lien of a second mortgage bond is a junior lien to that of the first mortgage bond.

When several different issues of bonds are secured by the same property, those having the superior lien are sometimes styled "underlying" bonds, the term indicating that they are closer to the property and have a superior or prior claim. Thus, if first and second mortgage bonds are secured on the same property, the first mortgage bonds are underlying bonds. If third mortgage bonds are also issued, both first and second mortgage bonds are underlying bonds.

§ 190. Gold, etc., Bonds

A bond may in express terms provide for payment in gold, silver, legal tender money, etc. Such provisions are legal and enforceable. If no medium is specified in which payment of a bond must be made, legal tender is always understood.

§ 191. Convertible Bonds

A convertible bond is one which, under prescribed conditions, carries the right of conversion into other securities of the same corporation. The usual form of convertible bond is that which may be exchanged for common or preferred stock of the issuing corporation at a fixed rate of exchange and within a certain period.

The American Telegraph and Telephone Company issued on March 1, 1913, \$67,000,000 of twenty-year convertible 4½% bonds. These bonds were made convertible at par into common stock of the company at \$120 per share (par value \$100) from March 1, 1915, to March 1, 1925. It is apparent, therefore, that the price of the bonds

should follow any advance in price of the stock, while their investment value should prevent their following any downward trend the stock might take. The stock of this company on March 1, 1915, sold around \$120 per share, and the bonds at par, so that an exchange on that basis would appear to be profitable when it is considered that the stock is paying dividends at the rate of 8%. By depositing \$600 par of bonds on which the holder previously netted an income of \$27, he might receive in exchange \$500 par of stock with a market value of \$600, but on which the income is \$40, or $6\frac{2}{3}\%$ on the investment. This is an increase of \$13 in his annual income. The holder of a \$100 bond was permitted to exchange it for one share of stock by paying the additional \$20 in cash; or if his holdings of bonds were larger, he was permitted to take the nearest even number of shares of stock and receive the difference in his favor, if any, in cash. June 15, 1916, this same stock sold around \$130 per share, giving a direct and substantial cash profit on the exchange.

It is obvious that the conversion privilege gives a bond a speculative character which adds greatly to its attractiveness as an investment. If the stock of the issuing company advances materially, the exchange can be made at a profit. If the stock does not advance, the bonds themselves are still a good investment. In short, the plan combines the safety of a bond investment with the profit possibilities of an investment in stock. (See also § 272.)

§ 192. Serial Bonds

These bonds are issued in series, one series payable each year, until the entire issue has been redeemed. If, for instance, the bonds cover ten years, the first series will have one year to run; the second, two years; the third, three years; and so on, until the final series, which will have ten

years. Coupons are attached to each series corresponding with the number of years the bonds have to run. (See also § 271.)

Serial bonds were formerly issued only by municipalities, or by companies whose credit rating was not high, but it is usual now for strong corporations to adopt this type, and the fact that it is selected does not mean that the company is financially unstable. It is believed by many to be the most satisfactory basis on which to raise funds for capital improvements. In some cases the serial bond is insisted on by the bond houses which are asked to underwrite the issue; in others it is demanded by the investors; and not infrequently it is preferred by the issuing company itself.

Serial bonds might be debentures, but are usually secured by a mortgage of the company's properties covering the entire issue. When this is the case it is obvious that, as one series of the bonds is paid off each year, the security back of the remaining series automatically increases, so that the margin of security to the investor is constantly growing larger. While this may be an advantage to the investor, it is sometimes disadvantageous to the issuing company which has all the securing property tied up until the last instalment of the bonds is paid. To prevent this, the terms of the issue not infrequently provide for the relinquishment of portions of the security after given redemption stages have been reached.

§ 193. Redeemable Bonds

Redeemable bonds are issued with the proviso that the issuing corporation may redeem or call them before the arrival of the date of maturity fixed by the deed of trust, either for cancellation or for sinking fund purposes. There are many bond issues of this nature, containing provisions

that the bonds may be redeemed, all or in part, at a stated price and accrued interest at the option of the company, on any interest day after a given date on 90 days' notice, notwithstanding the fact that the maturity date is far removed.

Frequently, when the redemption privilege is retained by the issuing corporation, it is provided that a premium shall be paid upon the bonds redeemed before maturity, which are usually selected by lot. Thus the sinking fund provision of the deed of trust securing the ten-sixty-year 5% sinking fund gold coupon bonds of the United States Steel Corporation, provides that at any time after ten years from the date of issue, any outstanding bonds may be redeemed by payment of the principal and a premium of 10% of such principal together with all accrued interest; bonds redeemed to be selected by lot and redemption to be confined to coupon bonds until all outstanding coupon bonds are redeemed. (See also §§ 260, 261, 267, 268.)

§ 194. Profit-Sharing, etc., Bonds

Profit-sharing bonds, or dividend bonds, or participating bonds, as they are variously termed, are bonds which in addition to their regular interest are entitled to some participation in the dividends of the company. The dividends paid on a profit-sharing bond may be limited to a fixed amount or percentage, or be conditioned otherwise, or the bond may participate as fully as does the common stock of the company.

It is obvious that such a provision gives the bond a speculative character which adds materially to its attractiveness as an investment. If it participates fully on the same basis as does the stock of the corporation, it has all the safety of a bond with all the profit possibilities of stock, and is preferable to a convertible bond because the

bond features do not have to be sacrificed to secure the profit-sharing stock possibilities.

§ 195. Income Bonds

An income bond is one which relies upon the net income of the company for its interest payments. It is a lien on the net income, but, unless profits are earned, its interest is not an obligation of the company. Such bonds differ from preferred stock only in the fact that their principal is an absolute obligation of the company and must be paid at the maturity date. Income bonds are sometimes termed debentures. (See §§ 183, 232.)

Income bonds may be either cumulative or non-cumulative as to interest. The principal may be secured or unsecured.

§ 196. Collateral Trust Bonds

A collateral trust bond is one which is secured by collateral—usually stocks and bonds of other corporations owned by the issuing corporation. These are deposited with a trustee under an agreement setting forth the conditions of the trust. Such a bond is frequently termed a “debenture.” (See also §§ 183, 273.)

§ 197. Guaranteed Bonds

A guaranteed bond is one the payment of which, either as to interest or principal, or both, has been guaranteed by some other corporation. Such a guarantee must be in writing and must either be written on the instrument itself, or be attached to it, to be effective.

Under proper conditions such guaranteed bonds are legal and are frequently issued. Thus, the bonds of a subsidiary railroad may be guaranteed by the parent road, or a bond of a constituent corporation may be guaranteed

by the holding company or trust of which it forms a part. (See also §§ 221, 231, 276.)

§ 198. Consolidated, etc., Bonds

Consolidated bonds, adjustment bonds, reorganization bonds, and refunding bonds are used, as their names indicate, in the various consolidations and adjustments common in the combinations or reorganizations of railroads and of the larger industrial corporations.

Thus, a consolidated bond will be used to retire two or more smaller issues, the new bonds usually being secured upon the properties which previously supported the retired issues.

Refunding bonds are those used to replace or redeem bonds which are maturing. Usually refunding bonds carry a lower rate of interest than the bonds they replace, although if the money conditions are difficult at the time, the interest rate may be the same or even higher. Refunding bonds are sometimes exchanged directly for the old bonds, or otherwise are sold to provide money for the retirement of the maturing bonds.

Adjustment bonds are those used in readjustments or consolidations of existing indebtedness. Reorganization bonds, issued when a corporation is in process of reorganization, are usually employed to take up, or as a substitute for, other outstanding issues. They are generally the regular first mortgage bonds.

§ 199. Interest Bonds

Interest bonds are those issued in payment of interest due on bond issues when cash is not available for the purpose. They preserve the interest from default and thereby prevent foreclosure and the other legal complications of a default.

§ 200. Terminal, etc., Bonds

Terminal bonds are those issued by and secured on the property of a terminal company which is, as a rule, subsidiary to the railroad or steamship line using the terminal. Such bonds are usually issued for terminal purchases or improvements. Extension bonds are those issued by a railroad to extend its lines. Equipment bonds are those issued for equipment, usually by a railroad company, though they might be issued in connection with an industrial corporation. Construction bonds, as their name indicates, are issued to secure money for the purposes of construction.

§ 201. Car Trust Bonds

Car trust or equipment trust bonds or certificates are issued by a trustee who holds for their security, equipment purchased or leased by a railroad company. The money realized from the sale of these bonds goes to the manufacturers or vendors of the equipment, or the bonds may be turned over to them direct. The railroad company receives its equipment subject to the trust agreement, and retires the equipment bonds in such amounts and at such periods as are fixed by the trust agreement. The title to the equipment does not usually vest in the railroad company until all the bonds are redeemed. This is a favorite kind of bond for some railway companies and is popular with many street railway companies.

Bonds and notes of this character are usually issued in series, redeemable in their serial order as payments are made by the railroad company. When the final payment is made by the railroad company, the deed of trust by which the property is held is released and the equipment becomes the property of the purchasing company. (See also §§ 224, 275.)

§ 202. Purchase Money Bonds

Purchase money bonds are those given to secure funds for the purchase of the property by which they are secured.

§ 203. Short Term Notes

A short term note is merely a corporation's promissory note. It may be secured or unsecured. If secured, it is usually by the deposit of collateral with a trustee under a trust agreement. The larger issues generally have coupons attached and differ but little from the usual bond, except in their early maturity.

Short term notes are issued when the existing conditions are unfavorable for a long time loan, and usually either carry a larger rate of interest than a bond issue, or are sold at a discount that produces the same practical result. Short term notes are usually floated with the expectation that they will either be retired at maturity or will be taken up by a bond issue on more favorable terms than would have been possible at the time the notes were issued.

Short term notes usually run from one to five or six years. The security deposited with the trustee consists of bonds and stocks of other companies, on almost the same plan as collateral trust bonds. These notes are issued under varying conditions, and their tenor and redemption features give to them such designations as "collateral lien notes," "collateral trust serial notes," "collateral gold notes," etc. Any one of these titles might contain the word "guaranteed" in case that is a feature of the note. (See also § 223.)

CHAPTER XVI

BOND FORMS

§ 204. Form of Bond

The language of a bond is usually more formal than that of a note. It must be executed under seal, and, if secured, reference is made in the bond itself to the deed of trust under which it is issued.

Usually a statement of the general conditions of a bond issue appears upon the face of each bond, and reference is made to any features of special importance, such as the existence of a sinking fund, the conditions of redemption, the method of transfer and exchange when bonds payable to bearer and registered bonds are issued under the same deed of trust, etc., etc.

Following is the form of coupon bond, with privilege of registration, used by the United States Steel Corporation:

UNITED STATES OF AMERICA
STATE OF NEW JERSEY

UNITED STATES STEEL CORPORATION

TEN-SIXTY-YEAR FIVE PER CENT SINKING FUND GOLD
COUPON BOND

\$.....

No.....

UNITED STATES STEEL CORPORATION, a corporation created and existing under the laws of the State of New Jersey, and hereinafter termed the "Steel Company," for value received promises to pay, on the first day of April, A. D. 1963, at the office or agency of the Steel Company in the City of New York, to bearer, or if registered, to the registered holder of this bond, ... thousand dollars in gold coin of the United States, of the present standard of weight and fineness, and to pay interest thereon from April 1, 1903, at the rate of five per cent per

annum, such interest to be payable at such office or agency in like gold coin semiannually on the first day of May and of November in each year (except that the first instalment is to be for seven months and the last for five months interest), but only upon presentation and surrender of the respective coupons for such interest hereto attached as they severally mature. All payments upon this bond, both of principal and interest, shall be made without deduction of any tax or taxes which the Steel Company, its successors or assigns, may be required to pay, deduct, or retain therefrom under any present or future law of the United States, or of any State, County, or Municipality therein.

This bond is one of a duly authorized issue of coupon bonds and registered bonds of the Steel Company, the aggregate amount whereof is limited so that there shall never at any one time be outstanding bonds of said issue for an aggregate principal sum exceeding \$250,000,000; all of which bonds have been issued, or are to be issued, under and in pursuance of, and are to be secured ratably by, and are subject to, an indenture dated April 1, A. D. 1903, duly executed by the Steel Company to the United States Trust Company of New York, as Trustee, covering, subject to the prior lien of the indenture dated April 1, 1901, executed by the Steel Company to the United States Trust Company of New York, all the stocks, bonds, and other property now or at any time hereafter subject to said indenture dated April 1, 1901, and all the stocks, bonds, and other property that by the terms of said indenture dated April 1, A. D. 1903, shall be subject to the lien thereof; and hereby reference is made to said indentures with the same effect as if herein fully set forth.

No recourse shall be had for the payment of the principal or interest of this bond against any stockholder, officer, or director of the Steel Company, either directly or through the Steel Company, by virtue of any statute or by enforcement of any assessment or otherwise; any and all liability of stockholders, directors, and officers of the Steel Company being hereby released.

This bond shall pass by delivery unless registered in the owner's name on the books of the Steel Company at its office or agency in said City of New York, such registry being noted on the bond by the bond registrar of the Steel Company, after which no transfer shall be valid unless made on said books in the manner prescribed in said indenture, and similarly noted on the bond; but the same may be discharged from registry by being transferred in like manner to bearer, after which transferability by delivery shall be restored; but again, from time to time, it may be registered or transferred to bearer as before. Such registration, however, shall not affect the transferability of the coupons for the interest hereon, by delivery merely, and payment to the bearer thereof shall discharge the Steel Company in respect

of the interest therein mentioned whether or not the bond shall have been registered.

This bond, with the coupons for all interest instalments which shall not have matured, may also, as provided in said indenture, be exchanged for a registered bond without coupons for an equal aggregate principal sum.

Neither this bond nor any coupon for interest thereon shall become or be valid until the bond shall have been authenticated by the certificate indorsed hereon duly signed by the Trustee under said indenture.

This bond is subject to redemption at the pleasure of the Steel Company as provided in said indenture, on any first day of May or any first day of November, after April 1, 1913, by payment of the principal of the bond and the unpaid accrued interest, together with a premium of ten per cent of such principal. The Steel Company annually will pay the sum of \$1,010,000 to the Sinking Fund Trustees under said indenture, which sum is to be applied to the redemption of bonds of said issue, in the manner provided in said indenture.

No action or proceeding at law or in equity shall be instituted or shall be maintainable upon this bond or upon any of the coupons hereof for the enforcement or collection of interest or for maturing the principal thereof by reason of any default in payment of any instalment of interest hereon, until after such instalment thereof shall have been unpaid and in default for the continuous period of two years, nor except when and as permitted by the terms of said indenture.

IN WITNESS WHEREOF, said United States Steel Corporation has caused these presents to be signed by a Vice-President, and its corporate seal to be hereunto affixed, and to be attested by its Secretary or by an Assistant Secretary, and coupons for such interest bearing the engraved fac-simile signature of its Treasurer to be attached hereto, the first day of April, A. D. 1903.

UNITED STATES STEEL CORPORATION

[SEAL]

By.....

Vice-President

Attest:

.....

Secretary

This bond, as will be noted, may be registered if desired and may again be restored to its first condition of transferability by delivery. Its registration does not, however, affect the coupons which pass by delivery alone and are payable to bearer regardless of whether the bond be regis-

tered or transferable by delivery. This would be the case without provision therefor in the bond, unless the coupons contained express stipulations to the contrary.

A shorter form of coupon bond as used by a smaller corporation is as follows:

THE NATIONAL PAPER COMPANY

FIRST MORTGAGE SIX PER CENT GOLD COUPON BOND

No. 35

\$500

KNOW ALL MEN BY THESE PRESENTS, That The National Paper Company, a corporation organized and existing under the laws of the State of New York, is indebted, and for value received promises to pay, to the bearer hereof, or to the registered holder of this bond, if the same be registered, the sum of Five Hundred Dollars (\$500) in gold coin of the United States of the present standard of weight and fineness, on the first day of October, 1921, at the office of the said Company, in the City of New York, with interest at the rate of six per cent per annum, payable semiannually at said office, in like gold coin, on the first days of October and April in each year, upon surrender of the annexed coupons therefor as they severally mature.

Both the principal and interest of this bond are payable without deduction for any United States, State, Municipal, or other tax or taxes which said The National Paper Company may be required to pay or deduct therefrom under or by reason of any present or future law, the said Company hereby agreeing to pay such tax or taxes.

This bond is one of a series of coupon and registered bonds of The National Paper Company, bearing interest at the rate of six per cent per annum, issued or to be issued in pursuance of, and subject to, the terms of the mortgage or deed of trust hereinafter referred to, but so that the aggregate amount of said bonds, both coupon and registered, shall not exceed the total sum of Thirty Thousand Dollars (\$30,000). All of said bonds are equally secured by a mortgage or deed of trust, dated October 1, 1916, executed by The National Paper Company to Charles White of the City of New York, as Trustee, conveying the property and franchises of The National Paper Company mentioned in said mortgage or deed of trust, to which reference is hereby made for a description of the property and franchises mortgaged, and the nature and extent of the security, and the rights of the holders of said bonds under the same, and the terms and conditions upon which said bonds are issued and secured.

This bond may be registered, in the name of the owner, on the

books of the Company, such registration to be indorsed hereon, and thereafter no transfer shall be valid unless made on the books of the Company by the registered owner and similarly indorsed hereon, but said bond may again be made payable to bearer by like transfer, and thereafter pass by delivery until again registered. Notwithstanding such registration the coupons hereon shall remain and be negotiable by delivery and payable to bearer on presentation.

This bond shall not become obligatory for any purpose until it shall have been authenticated by the certificate, hereon indorsed, of the Trustee under said mortgage or deed of trust.

IN WITNESS WHEREOF, The National Paper Company has caused these presents to be signed by its President, and its corporate seal to be hereunto affixed, and to be attested by its Secretary, and coupons for said interest, with the engraved signature of its Treasurer, to be attached hereto, this 1st day of October, 1916.

THE NATIONAL PAPER COMPANY

[Seal]

By.....

President

Attest:

.....

Secretary

§ 205. Form and Nature of Coupon

A coupon, as already stated (§ 185), is in form a promissory note. It is attached to the bond as a convenient method of indicating the amount and the due date of interest, and of the collection of this interest when due. One coupon is attached to the bond for each interest instalment. Thus a twenty-year bond with semiannual interest payments would carry forty coupons. These coupons are numbered serially, and also carry the number of the bond to which they are attached. Coupon No. 1 represents the interest that will be due at the first interest period. As soon as that period arrives, the coupon is said to mature, and it is then detached from the bond and either presented for payment or deposited for collection, as would be done with any other promissory note. Coupons may be detached from the bond before maturity and sold independently of the

bond. The possession of the coupon is sufficient evidence of ownership in the absence of proof to the contrary, and, as a coupon is payable to bearer, no indorsement is necessary or usual when it is presented for payment or deposited for collection.

When an interest payment on coupon bonds is about to fall due, the amount necessary to meet the maturing coupons is usually deposited in some designated bank or trust company which acts for the corporation and pays the coupons as they are presented. The coupons are then cancelled and are pasted in the coupon register (§ 214).

The form of coupon used in connection with the bond of the United States Steel Corporation shown on the preceding pages is as follows:

No. \$.....

Coupon for \$....., gold coin of the United States of America, payable to bearer on the first day of, at the office or agency of the United States Steel Corporation in the City of New York, without deduction for taxes, for months interest due on that day on the \$..... Ten-Sixty-Year Five Per Cent Sinking Fund Gold Bond of United States Steel Corporation, No., subject to the terms of said bond, and of the indenture dated April 1, 1903, therein mentioned.

.....

Treasurer

Coupon (U. S. Steel Corporation)

§ 206. Trustee's Certificate

Bonds issued under a deed of trust must be certified by the trustee before they are issued. The trustee's certificate appears on the back of each bond, and evidences the fact that the bond is one of the issue mentioned in the deed of trust. This certification is not part of the bond, though it may be required before the bond itself can be considered as issued, nor is it in any sense an indorsement of the bond

nor a certification of its correctness as to form or subject matter. The object of the trustee's certificate is to identify the bond and to prevent overissues. If the trustee certifies more bonds than are called for by the deed of trust, he may make himself personally responsible for the overissue, but he incurs no liability whatsoever by reason of any proper certification.

The form of trustee's certificate indorsed on the bonds of the United States Steel Corporation is as follows:

THIS IS TO CERTIFY that this bond is one of the issue of bonds of United States Steel Corporation mentioned in the indenture dated April 1, 1903, within referred to, executed by United States Steel Corporation to the undersigned as Trustee.

UNITED STATES TRUST COMPANY OF NEW YORK

By.....

Trustee's Certificate

§ 207. Deed of Trust

A deed of trust is a mortgage on certain specified property given to a trustee who acts for the holders of the bonds secured thereby. The deed of trust recites at length the terms and conditions under which the bonds are issued and under which the property for their security is held.

A modern deed of trust is usually a very comprehensive and formidable instrument. A brief form may occupy perhaps from ten to twenty pages of printed matter. More extended forms frequently occupy one hundred pages or more.

In the bond itself reference is always made to the deed of trust by which it is secured, and in the deed of trust the bond is recited in full. The bond by express terms is subject to the conditions of the deed of trust. Accordingly, the statements of the bond are controlled by the explanations and any non-conflicting conditions of the deed of trust.

If the deed of trust should fail for any reason, the bonds then become the unsecured obligation of the corporation, and take their place on a parity with the other unsecured corporate debts.

§ 208. Recitals of Deed of Trust

In the deed of trust usually employed, the preamble recites the conditions precedent to the issue, gives the form of bond in full, and the form of coupon and trustee's certificate, also in full; followed by the granting clauses, which include a description of the property covered, and by the trust reservation with stipulation for equal participation of all the bonds of that issue in the protection afforded by the mortgaged property.

Following this come the "covenants, conditions, uses, and trusts" subject to which the bonds are issued and the mortgaged property is held. These have a wide range. Some of the more usual of the matters provided for are as follows:

1. Procedure for execution, certification, and delivery of bonds.
2. Enjoyment of property by mortgagee until default.
3. Payment of principal and interest without deduction for taxes, and in "gold coin," "legal tender," or otherwise, as the case may be.
4. Payment of all taxes and assessments on property held under the deed of trust, and, if the nature of the property is such as to require it, maintenance of the same in repair, under due insurance and freedom from liens.
5. Provision that the deed of trust shall be a first mortgage—if such is the case—and be duly executed, recorded, and maintained.

6. Provision for any necessary additional assurances for protection of bondholders.
7. Provision for trustee to enter upon property and conduct business without foreclosure under certain conditions.
8. Creation of sinking fund for retirement of bonds.
9. Procedure for foreclosure in case of default.
10. Provision that bonds shall be matured by failure to pay interest.
11. Stipulation that loans, advances, or payments made on coupons for account of the mortgagee shall not keep such coupons alive.
12. Provision for redemption of bonds.
13. Provision for discharge of deed of trust.
14. Provision for substitution or appointment of new trustee.
15. Disclaimer of responsibility on part of trustee.
16. Interpretation of terms used in deed of trust.
17. Provision that deed of trust may be executed in duplicate.

In addition to these common provisions, others are often dictated by particular conditions. Thus, if both registered and coupon bonds are issued, provision must be made for registration and for the exchange of one kind of bond for the other if this is prescribed. Provisions may also be inserted for the issue of temporary certificates, or for replacement of destroyed or mutilated bonds, or for discrimination against coupons detached or assigned before maturity, or for exemption of the stockholders and officers of the issuing company from all liability under the deed of trust or for the bonds issued thereunder. In a mortgage on réalty it may be provided that upon payment to the trustee of a certain specified price, parts of the property

may be sold free from the encumbrance of the mortgage, or that under prescribed conditions properties may be withdrawn from the mortgage and new properties substituted in their place.

§ 209. Duties of Trustee

The duties of the trustee under a deed of trust are usually few, but may be onerous. He certifies each bond issued. At times the recording of the deed of trust is made one of his duties. In case of default he is usually required either to take possession of the property and operate it or sell it, according to the conditions of the deed of trust, for the benefit of the bondholders. If called upon to operate the property, his duties and liabilities may be heavy. If the property is operated at a loss, he may be responsible for the deficit.

The trustee makes an annual charge for the service rendered to the issuing corporation, but as a rule the duties are few and the fee correspondingly low.

§ 210. Execution and Filing of Deed of Trust

The deed of trust is executed with the same formality as a deed of land. It must be signed and sealed both by the corporation and by the trustee, and be duly acknowledged before a notary public or other duly authorized officer. The corporate signature is usually affixed by the president, and the corporate seal is affixed and attested by the secretary. The acknowledgment is also usually made by the president of the corporation, but is of equal force if made by the secretary, treasurer, or any other duly authorized executive officer. It is immaterial whether the deed of trust be executed within the state in which the corporation was organized or elsewhere.

If realty is included, the deed of trust must be filed in

the office of the county clerk in every county in which the real estate is situated.

§ 211. The Bond Register

If bonds issued by a corporation are sold through an underwriting syndicate, or through a bank or trust company which acts as transfer agent and registrar, the corporation need maintain no special record of the transaction beyond making the proper entries in its books of account. If, however, the bonds are sold by the corporation direct, the treasurer or the accounting department must keep a more detailed record, and for this purpose a bond register is necessary. If coupon bonds are issued, a coupon register also must be kept for each denomination of bond.

Registered bonds are, as already stated (§ 186), of two classes: (1) bonds which are registered both as to principal and interest, interest checks being issued on the specified interest dates direct to the holders of record; and (2) bonds which are registered as to principal only, the interest being represented by coupons and therefore payable to the holders of these coupons upon surrender of the same.

The principal record for the registered bond is the bond register. An index of bondholders is also usually maintained. This is merely a card list on which is entered the name and address of each bondholder, together with the number of his bond, its amount, and such other data as may be desirable. The card also provides for a record of the party from whom the bond was transferred, in case it is not an original issue, and blanks for name of party to whom it is transferred, in case of transfer. (See page 235.)

§ 212. Form of Bond Register

The bond register shown below provides space for the name and address of the holder, the number of his bond,

CLASS Registered 1st Mortgage 1925

	NO	DATE OF BOND	TO WHOM ISSUED		TRANSFERRED		AMOUNT
			NAME	ADDRESS	NAME	ADDRESS	
1	4000	1915 July 1	James Moran	449 West 87th St. New York City			1000
2	~~4001~~	~~July 1~~	~~A. B. Jacobson~~	~~Brookline, Mass.~~	Wm. R. Gilbert	Brookline, Mass.	~~1000~~
3	4002	Oct. 15	Henry R. Dale	Garrison, N.Y.			500
4	4003	Feb. 12	L. D. Hurst	500 Chestnut St. Boston, Mass.			250
5	4004	Mar. 20	Ralph B. Gray	374 Park Ave. New York City			1000
6	4167	1917 Jan. 1	Wm. R. Gilbert	Brookline, Mass.			1000
7							
8							
9							
10							
32							
33							
34							

Bond Register (left-hand page)

INTEREST PAYABLE										January 1 st & July 1 st									
INTEREST DATE	1916		1917		1918		1919		REMARKS	1924		1925							
	JAN.	JULY	JAN.	JULY	JAN.	JULY	JAN.	JULY		JAN.	JULY	JAN.	JULY						
1915 July 1	30	- 30	- 30	- 30	-	-	-	-						1					
" 1	30	- 30	- 30	- 30	(See No. 44167)	-	-	-						2					
1916 Mar. 1	5	- 15	- 15	- 15	-	-	-	-	Recd. Out 7/15 to 1/1/15 \$10.00					3					
" 1	-	- 5	- 5	- 5	-	-	-	-	" " 1/1/16 - 3/1/16 \$2.50					4					
" 1	-	- 20	- 30	- 30	-	-	-	-	" " 1/1/16 - 3/1/16 \$10.00					5					
1917 Jan. 1	-	-	-	- 30	-	-	-	-	Trans. from #4001					6					
														7					
														8					
														9					
														10					
														31					
														32					
														33					
														34					

Bond Register (right-hand page)

the date it was acquired, the party to whom transferred, and twenty columns for twenty interest payments. Thus a complete record is provided for a ten-year bond on which interest is payable semiannually.

When a registered bond is transferred, a new one is issued on surrender of the old, just as a new stock certificate is issued when stock is transferred. The surrendered bond is cancelled and filed, and in the bond register a red-ink line is ruled through the name and address of the former owner, and through the number and amount of the cancelled bond itself. Also the number of the new bond is written directly after the last entry of interest payment on the old bond, as indicated on the form shown. A line ruled through the remaining interest columns then completely cancels the line devoted to the cancelled bond, though the original entry still shows the transfer of the old bond and the number of the new bond by which it was replaced. The name and address of the owner of the new bond is then recorded on the first vacant line of the bond register in the column headed "To Whom Issued," and the record of the transfer is complete.

As will be noted, the bonds are entered in numerical order, and any special bond may be readily located if its number is known. If the number is not known but the name of the owner is, the bond may be traced through the index of bondholders. If desired, the number of the page of the bond register on which the individual's name appears can be entered on the index of bondholders, a copy of which is shown on page 235.

The difference between the footings of the "Amount" columns of the bond register and the sum total of all bonds cancelled—which is obtained by adding together all amounts through which the red-ink line is drawn—should agree with the balance of the Bond account in the general ledger.

BOND NO. E 455	AMOUNT <u>\$1000⁰⁰/₁₀₀</u>	CLASS Reg. Deb. 6% 1926
NAME <u>Hayden, John R.</u>		
BONDHOLDER'S ADDRESS		TRANSFERRED TO
Post Office <u>New York City</u>		Name
County <u>New York</u>	State	Address
Street and No. <u>269 West End ave.</u>		
Transferred From <u>William Scott</u>		

Index of Bondholders

If the bonds are not coupon bonds, interest is computed on each at the half-yearly or yearly interest dates, and recorded under the proper interest period in the bond register. At the same time, interest checks are issued to the registered holders. The sum total of the footings of the "Interest" columns should agree with the total amount of interest checks issued, and is charged through the cash book to the "Accrued Interest on Bonds" account. This is on the assumption that accrued bond interest is entered monthly or at least prior to the date of payment.

Interest checks are made out direct from the bond register. For the sake of accuracy, it is advisable to arrange these interest checks alphabetically and compare the names of the payees with the names shown by the cards of the index of bondholders. This reduces to a minimum the possibility of checks being made payable to the wrong person.

The register for coupon bonds does not show interest payments, but merely the ownership of the bonds. In such case the rulings for interest payments are omitted. The

bonds are entered as presented for registry rather than numerically as is the case with registered bonds.

§ 213. Payment of Coupons

Coupons are generally presented for payment at the office of the fiscal agent or trustee, in envelopes specifying the title of the security, number and amount of the coupons, and the name of the concern or individual presenting them. Payment is made by check when possible, and, of course, out of funds supplied by the issuing corporation. The coupons are cancelled by having one or more holes punched in them; all cancelled coupons are kept together, and at proper intervals are sent to the company which issued the security, with a statement of the account showing the total coupons paid and the amount still outstanding.

The following is a form of report of coupons paid:

THE ANNUITY TRUST COMPANY

PHILADELPHIA, PENNSYLVANIA

Gentlemen:

We send you herewith by a package containing cancelled coupons amounting to \$....., from bonds of your Company as set forth in the attached receipt, having been paid by us out of funds deposited by your Company for that purpose.

Please sign and return the accompanying receipt.

Very truly yours,

.....

Manager, Corporate Trust Department

Report of Coupons Paid

Attached to this report, or accompanying it, is a receipt setting forth the amounts and the numbers of the various cancelled coupons. This is signed by the company issuing the bonds and returned to the trustee. A common form of receipt reads about as follows:

TRUST DEPARTMENT

THE ANNUITY TRUST COMPANY

PHILADELPHIA, PENNSYLVANIA

\$.....

Date.....

Received of The Annuity Trust Company the following:

..... coupons # for \$..... for interest
 due date on bonds of
 Company, numbered (*here give the numbers of the coupons cancelled*),
 duly cancelled and paid by said Trust Company out of funds deposited
 by this Company for that purpose.

.....

*Treasurer**Receipt for Coupons Paid***§ 214. The Coupon Register**

Coupon bonds registered as to principal are entered in the bond register, and an alphabetical card index of bondholders is provided for each denomination of bonds issued. A coupon register is also provided for the proper record of paid coupons.

If coupon bonds are not registered, but are transferred by delivery, the bond register and the card index of bondholders are, of course, unnecessary, the coupon register alone being maintained. This coupon register is shown below.

An entire page of the coupon register is required for the record of each bond, and all paid coupons belonging to that bond are pasted on the page allotted to it in the space numbered to correspond with the particular coupon. The method of using the coupon register is simple. As will be noted, the number, the amount, and a brief description of each bond are entered at the top of the page devoted to that bond. As each coupon comes in and is paid, it is pasted over its number on this page. A glance at the coupon register will therefore show at any time what

METROPOLITAN INVESTMENT CO.			E 455
BOND REGISTER			
\$1,000 ~~00~~ .		6% TRUST BOND	
Dated <u>Jan. 1, 1916</u> Due <u>Jan. 1, 1926</u> First Coupon due <u>July 1, 1916</u>			
		14	7
	20	13	6
	19	12	5
	16	9	2
	15	8	CANCELLED COUPON

Coupon Register

coupons have been paid and also what coupons are due but unpaid.

A special bank account should be kept for the payment of coupons, and the balance of this bank account should agree with the total amount of the coupons due and unpaid as shown by the coupon register.

CHAPTER XVII

BOND SALES

§ 215. Selling the Bonds

After the bond issue is authorized and all other preliminary formalities completed, the important question is, "How can the bonds be sold to the best advantage?" This question can be answered only in the light of specific conditions—as, for instance, the stability of the issuing company, the kind and condition of property offered as security, whether or not the bonds are indorsed or guaranteed by a stronger company, the rate of interest to be paid, the length of time to run, the redemption provisions, and the condition of the money market at the time of sale. The manner of disposing of the bonds and the agencies through which they are to be sold also have an important bearing upon the success of the issue. If they are sold through some well-known banking house, their attractiveness is much increased, for this practically amounts to an indorsement of the bonds, as such bankers before taking bonds for sale always make a careful investigation of the reliability of the issuing company and of the conditions underlying the bonds. For this purpose the larger bond houses employ a staff of experts composed of engineers, appraisers, attorneys, accountants, etc.

Large bond issues are nearly always sold to, or through, underwriting syndicates or financial institutions which make a business of such work. The syndicate or banker agrees to take the bonds at a certain figure and to assume the risk of selling them. If, as is sometimes the

case, bonds are sold through a financial agent, this agent simply acts for the corporation, selling the bonds at the highest figure possible and receiving his compensation in commissions.

Bonds may sell at, or below, their par value, or at a premium, depending upon the stability of the issuing company and the rate of interest to be paid. The bonds may be all or partly sold at the time of issue, and those that have been disposed of may be paid for in monthly or periodical instalments. In any case, there are numerous expenses incident to a bond issue, and these may either be charged immediately to operating expenses or spread over a term of years.

§ 216. Bond Issue Regulations

A proposed bond issue of a public utility corporation must have the sanction of the public service commission of the state in which the corporation is located before it may be issued. This serves as a protection to the public at large, the stockholders of the corporation, and the purchasers of the bonds. Not only do these commissions regulate the bond issues of corporations, but they prescribe among other things the classifications of accounts to be used by companies operating within their jurisdiction. The following entries for bond issues of public utility companies are in accordance with commission regulations.

Commission regulations place bond issues under the heading of "Funded Debt," each issue being designated by the kind and tenor of the debt obligation incurred. The manner of making entries, however, differs slightly, if at all, whether the bonds are of one kind or another. Commission regulations as to bond issues are very much the same in different states.

§ 217. First Mortgage Bonds Sold at Par

To illustrate the sale of bonds at par, we will assume that the directors and stockholders of the Lenox Iron Works have authorized January 1, 1916, an issue of first mortgage gold bonds for \$1,000,000, having twenty years to run, with interest at 5%, payable semiannually on the first day of January and July. The bonds are coupon in form with the privilege of registration as to principal.

Under these circumstances, it might be permissible to ignore the matter as far as the books of account are concerned, until the bonds are sold, at which time an entry would be made only for those sold, as shown below. It seems prudent, however, to have a transaction of such importance placed upon the books immediately. For this purpose, at the date of issue and before sale of the bonds, an entry is made as follows:

January 1, 1916		
Unissued First Mortgage Bonds.....	\$1,000,000	
To First Mortgage Bonds.....		\$1,000,000
Authorized issue of \$1,000,000 first mortgage 5% twenty-year gold bonds as sanctioned this day by the directors and stockholders.		

Instead of "Unissued Bonds," some other appropriate title for the account may be used, if desired, as "First Mortgage Treasury Bonds," "Unsold First Mortgage Bonds," etc. The credit entry may, if desired, be made to "First Mortgage Bonds Payable," "Authorized First Mortgage Bonds," "Bonds Payable," or any other caption that will designate the issue clearly. If there are different issues, the caption may distinguish them by indicating the interest rate, the life, or the due date of the bonds, as "First Mortgage 5% Gold Bonds of 1950" or "First Mortgage 6% Twenty-Year Bonds," etc.

§ 218. Entry on Sale of Bonds

If the entire issue of bonds is sold by the issuing company for cash, the following entry* should be made:

Cash	\$1,000,000	
To Unissued First Mortgage Bonds		\$1,000,000
Sale at par of the entire issue of first mortgage bonds as authorized by the directors.		

In case the bonds are paid for in property of some kind, then, of course, the property received is debited in place of cash.

If the bonds were not recorded on the books at the time of authorization, the cash book entry would be:

Cash	\$1,000,000	
To First Mortgage Bonds.....		\$1,000,000
Sale at par of the entire issue of first mortgage 5% twenty-year gold bonds as authorized by the directors.		

In case only a part of the bond issue has been taken at the date of issue, then a cash book entry to Unissued Bonds account must be made for only the sum taken. Subsequent sales of bonds for cash should be recorded in the same manner. In the sale of bonds after date of issue, however, the element of accrued interest is involved in the sale price and must be included.

Unsold bonds should not appear as an asset in the balance sheet. In order that the sold and unsold bonds may be clearly distinguished, they should appear in the balance sheet about as follows:

First Mortgage 5% Gold Bonds:

Total Amount Authorized.....	\$1,000,000
Less Unsold Bonds.....	500,000
Bonds Issued and Outstanding.....	\$500,000

* All cash book entries are, as a matter of convenience, shown in journal form.

§ 219. Bonds Sold at Par and Accrued Interest

Inasmuch as the entire bond issue bears the date of authorization, it is apparent that interest will have accumulated on all bonds sold on subsequent dates. It matters not whether the bonds are sold at par or otherwise; interest will have accrued on the par value thereof to the date of sale, and the investor is expected to add it to the purchase price of the bonds. In that case the cash book entry would be as follows, assuming that \$500,000 of bonds were sold three months after the bonds were issued.

April 1, 1916		
Cash	\$506,250	
To Unissued First Mortgage Bonds....		\$500,000
" First Mortgage Bond Interest.....		6,250
Sale of \$500,000 of first mortgage bonds and accrued interest on same at 5% for three months.		

Payment of the full amount of accrued interest is in effect a payment of interest before it is due, and in the present illustration the purchaser loses the interest on \$6,250 from date of payment until the next interest date, i.e., three months. Outside of this, there is neither a loss nor a profit to either party, since in three months after the given date the company will pay the entire interest on all outstanding bonds for the first half-year; at that time the purchaser will receive back the interest money advanced by him, and in like manner the company will return the interest thus received. If the sale were deferred until the first or some subsequent interest date, accrued interest would not enter into consideration at all, for at that time the company would clip all coupons from the unsold bonds and, after cancellation, paste them in the coupon register without further entry.

§ 220. Bond Subscriptions Paid For in Instalments

If bonds are sold directly to the public by the issuing company, or even through brokers on a commission basis, it is not unusual to allow the purchasers a term of months in which to make their payments, the instalments being due at designated intervals. If the present bond issue had been sold to subscribers on the instalment plan, the entry would be:

January 1, 1916		
Bond Subscriptions.....	\$1,000,000	
To Unissued First Mortgage Bonds..		\$1,000,000
Sale of \$1,000,000 of bonds to sundry subscribers at par, payable one-quarter down and the balance in three monthly payments of one-quarter each on the first day of each month. (Names of subscribers should be entered on separate sheets or in a subsidiary subscription ledger provided for the purpose.)		

Bond Subscriptions should be credited as payment of each instalment is made, and official receipts be issued therefor. When payments are completed, the instalment receipts are returned and the bonds issued. The deferred instalments may perhaps bear interest at a given rate, or at the same rate the bonds are to draw, in which case an additional credit to Bond Interest account for the interest received is necessary, which in turn will offset an equivalent charge to the same account. Monthly balance sheets made during the interval would of course show the amount of bond subscriptions deferred.

Instalment payments may obtain when bonds are sold to the company's bankers. In that event the entire contract amount, after allowance for discount, if any, should be charged up to the brokers as shown below:

Barton and Day, Bankers.....	\$1,000,000	
To Unissued First Mortgage Bonds (or to First Mortgage Bonds)....		\$1,000,000
Entire issue of first mortgage bonds sold at 100 flat, payable \$400,000 down and the balance in two instalments of \$300,000 each, due in one and two months respectively.		

Credit is, of course, given Barton and Day, as payments are made by them.

§ 221. Guaranteed Bonds

When bonds of one corporation are guaranteed by another corporation, it is manifest that the guaranteeing corporation must constantly hold itself in readiness to pay the bond interest upon any default on the part of the issuing company; but were such payment made, it would be considered only as an advance or loan to the subsidiary company, from whom repayment would be expected at some future date. The entries to be made on the issuing and guaranteeing companies' books should be in harmony.

As to whether or not a ledger entry is required by either company at the time bonds are guaranteed, as an official record of the conditions, depends on the wishes of the directors. If a minute of such guarantee is clearly set forth in the official records of each company, that should suffice, since the fact of the guarantee is conspicuously stated in the bonds themselves as well as in the deed of trust. A foot-note of the guarantee should, of course, be made on the balance sheet of the guaranteeing company.

§ 222. Entries for Collateral Trust Bonds

As previously stated (§ 196), collateral trust bonds are bonds secured by a deposit of stocks and bonds of other corporations. This "collateral" usually represents

the company's entire or partial ownership of companies in the same or similar lines of business, and located in its own or in adjoining territory. The collateral stocks and bonds are deposited with a trustee in accordance with the trust agreement, and the market value of these securities is usually considerably more than the bonds which they secure.

Collateral trust bonds are frequently issued in the form of short term notes, or collateral trust serial notes, and when issued by underlying companies they may even be "guaranteed" by the holding, leasing, or parent company. The "guarantee" is not infrequently given by one or more individuals who are financially able to act as surety.

The book entries for collateral trust bonds do not differ materially from those required for recording regular mortgage bonds. With the mortgage bond, however, though a conveyance under trust mortgage is made to the trustee, the real estate security remains in the company's possession; while in the case of the collateral bond, all of the security is placed in the hands of the trustee. The terms of the trust indenture usually provide that the collateral may be changed at any time for other collateral of equal value, either at the request of the issuing company or of the trustee.

The collateral security must be conveyed to the trustee before the actual sale of bonds begins, though this conveyance does not deprive the company of its rights and privileges as owner of the collateral, such as voting at meetings of stockholders, receiving the income from its investment, etc. The question now arises, what kind of record should be made for the collateral deposited with the trustee? An adequate record of the transfer should, of course, be made in the official minutes, and the Public Service Commission of New York requires that the pledged

collateral must be set forth in an account by itself. Corporations not subject to commission regulations may make entries in any logical manner, but in all cases it seems desirable to set forth in a separate account all pledged securities.

The stocks and bonds used as collateral, when first purchased, are usually entered on the books at the purchase price regardless of par value, and are charged to some representative account, as "Investments" or "Stocks and Bonds of Other Companies," or to accounts representing the kinds of securities purchased.

On the assumption that the collateral is standing in an "Investments" account and has a book valuation of \$1,340,000, the following entry is required to suitably record the conditions:

Pledged Investments (To secure collateral	
trust bonds).....	\$1,340,000
To Investments.....	\$1,340,000
To record the pledge of the following collateral with the Hudson Trust Company, as security for the issue of \$1,000,000 collateral trust bonds: (Here list details of the stocks and bonds pledged.)	

The above entry removes the collateral entirely from the Investments account and leaves therein only such securities as are still in the company's possession; while the Pledged Investments account exhibits the book value of securities in the trustee's possession. In a manufacturing corporation an account might be opened with the trustee and the collateral security stated therein. If there are several bond issues, it is desirable to have separate accounts for the pledged collateral belonging to each issue.

It is obvious that the securities pledged to secure collateral bonds will fluctuate in value in harmony with

business conditions, and, if listed securities, their market value can be noted at any time. A permanent reduction in the value of the collateral deposited, or in any of the investments held by the company, should be recorded in the company's accounts by a charge to Profit and Loss and a credit to the accounts affected. In case the value of the listed securities rises, the change of value might be recorded if it were thought desirable so to do, by a charge to the accounts affected and a credit to Profit and Loss. In case the pledged collateral falls below a given margin of safety, the trustee has the right to call for an additional deposit.

Corporations which have a considerable investment in stocks and bonds usually provide separate books for recording the details of such investments. When this is the case, a notation in the accounts affected might perhaps be considered a sufficient record of securities deposited as collateral, but the entry shown above is preferable since it provides a more systematic record of the conditions.

§ 223. Entries for Short Term Notes

The opening entries for short term notes do not differ from those required for collateral trust bonds. An entry should, of course, be made crediting the entire issue of notes under whatever caption is necessary, as "Three-Year Notes," "Two-Year Collateral Trust Notes," etc., and debiting the cash received and selling expense. In case the notes are secured by collateral, an entry for the securing collateral is necessary as explained in the preceding example.

§ 224. Entries for Equipment Trust Serial Bonds

Equipment trust bonds, or car trust bonds (frequently called certificates), are secured by a mortgage on all or a

part of the equipment of a railway company. The trust agreement by its terms is in the nature of a lease. In other words, the transaction is a conditional sale, the company paying each year an annual instalment on the bonds, and the trustee—acting for the persons who advanced the money—holding a lien on the entire property specified until the last instalment, or rental, is paid, at which time a release is given. The bonds or certificates are usually put out in series, from time to time, as each succeeding series is issued, as "Series A," "Series B," "Series C," etc. As they are secured on the equipment, the margin of security increases automatically as the annual instalments are paid. These usually begin to mature early in the life of the property. Under the trust indenture, each car, locomotive, or other chattel is plainly marked so as to identify the mortgaged property, which the company must maintain in proper efficiency. While the equipment comes at once into the possession of the railway company, the full ownership is, from the nature of the case, deferred until the final bond instalment is paid, when the trustee releases the title to the company.

To illustrate the entries required when equipment trust bonds are sold, assume that the Green Valley Railway Company has issued equipment trust 5% gold bonds dated July 1, 1916, for \$4,000,000, payable in instalments of \$400,000 each year beginning July 1, 1917; the bonds are secured by new standard equipment costing \$5,000,000, upon which an initial payment of \$1,000,000 has been made by the company. Since the issue of equipment or car trust certificates is subject to commission regulations, these regulations must be followed in making the entries. Assuming that the equipment was purchased through, and the bonds given to, Murray Brothers & Co., bankers, at 95, and that a trust mortgage is made to a trustee as

security for the bondholders, and that expenses connected with the issue amount to \$6,000, the required entries are as shown below.

When the trust is created and the first payment of 20% is made on account of the equipment, the entry is:

July 1, 1916

Equipment	\$1,000,000	
To Cash.....		\$1,000,000
Initial payment of 20% on the following equipment costing \$5,000,000 purchased through Murray Brothers & Co., for which \$1,000,000 is paid in cash and the balance is satisfied by equipment bonds. (Here give details of the equipment and bonds, or else refer to the agreement where they can be found.)		

If thought preferable, the above and following payments might be put through the account of the bankers, who are holders of the lien; Equipment and Leased Equipment being debited and the bankers credited with the entire purchase price of the equipment.

July 1, 1916

Leased Equipment.....	\$4,000,000	
To Equipment Trust 5% Bonds.....		\$4,000,000
For issue of equipment trust bonds in denominations of \$1,000, being balance of payment of equipment purchased through Murray Brothers & Co., Bankers, as per trust agreement. The bonds mature \$400,000 on July 1 of each year during the next ten years.		
Expense on Equipment Trust Bonds.....	\$6,000	
To Cash.....		\$6,000
Expenses incurred in connection with the issue of equipment trust bonds.		

As each bond instalment matures and is paid, an entry is required in the bond account and also in the Equipment account, since the portion paid must be transferred from "Leased Equipment" to the "Equipment" account. The equipment is required, of course, to be fully and adequately maintained by the operating company. The entries for interest are required to be made semiannually, and monthly adjustments should be made to distribute the interest over its period. The instalment entries are:

July 1, 1917

Equipment Trust 5% Bonds.....	\$400,000	
To Cash.....		\$400,000
First instalment on equipment trust bonds paid this day, per trust agreement.		

At the same time, and at each instalment date thereafter, the following transfer entry is required:

Equipment	\$400,000	
To Leased Equipment.....		\$400,000
For transfer to the Equipment account, of property covered by current instalment.		

CHAPTER XVIII

BOND INTEREST

§ 225. Paying Bond Interest

Under the terms of the usual trust deed securing a bond issue, the trustee is empowered to enter upon and foreclose the mortgage upon default of interest payment. Therefore, the company is bound to meet its bond interest obligations, or else face a foreclosure suit with its possible receivership or bankruptcy. Whether the profits are sufficient or **not** to meet fixed charges, the bond interest must be paid.

Bond interest is usually paid semiannually from the date of issue, but it may be paid quarterly or annually. Interest on registered bonds is paid to the registered holders by checks sent out at interest periods by the company itself or by its fiscal agent, while interest on coupon bonds is paid upon presentation of the coupons at the office of the company or of its fiscal agent. The coupons are sometimes made payable at any one of two or three different agencies. Owners of coupons may either send them direct to the issuing company or agency and receive a cash remittance in exchange, or deposit them in their local banks for collection. (See also § 185, and Chapter XVI.)

§ 226. Method of Handling Interest Coupons

Using the bond issue of \$1,000,000 5% gold bonds of the Lenox Iron Works, cited in the preceding chapter, we assume that the first interest period, July 1, 1916, has

arrived and that \$25,000 has been turned over to the company's fiscal agent for payment of the coupons as they are presented. On the company's books the only entry required at the time is the following, which, of course, should appear in the cash book:

July 1, 1916

Bond Interest.....	\$25,000	
To Cash.....		\$25,000
For payment of semiannual bond interest on \$1,000,000 5% bonds, due today at the office of the trustee, The Grove Street Trust Company, to whom the check has been issued.		

The preceding entry is made immediately on sending the interest check to the trust company or bank where the coupons are payable. This check is usually sent the day before the interest is payable or perhaps sooner, depending on the distance. When the coupons are paid and cancelled, they are then turned over to the issuing company and by them pasted in the coupon register (§ 214), or otherwise disposed of.

In case the interest coupons are payable at the office of the company, it is obvious that, with the simple accounting system assumed, no entry would be necessary until the coupons were presented and paid. Even when the coupons are payable at the company's office, a special bank account is frequently opened for their payment, a check being drawn for the full amount and deposited under a special account. If the coupons were all paid on the due date, the entry would be similar to that given above, the explanation showing that payment was made at the office. It is but rarely, however, that this happens, and when it is not the case, entry is, of course, made only for the coupons presented and paid. The amount still

outstanding can easily be calculated, but the bond interest account itself will not show its correct debit until all of the coupons have been paid. It is apparent, therefore, that at the end of each year the books must either be kept open until all coupons come in, or present an incomplete record comprising only such bond interest as has been paid. Neither of these plans meets the needs of present-day accounting. The most approved plan is to set up at each interest date the amount of interest due. Assuming that this plan is adopted, the following entry is necessary at the end of the preceding month:

June 30, 1916		
Bond Interest.....	\$25,000	
To Bond Interest Payable.....		\$25,000
For half-yearly bond interest due and payable tomorrow.		

Instead of "Bond Interest Payable," the account might be termed "Coupons Payable" or "Bond Interest Accrued." There is a difference, however, between interest "due and payable" and interest "accrued." For instance, on June 1, 1916, the larger portion of the interest on the bonds for the period under consideration has accrued, but it is not due and payable until July 1, 1916.

Outstanding coupons continue to be obligations of the company until paid. As the coupons are redeemed, charges are made against Bond Interest Payable account, so that the excess credit to this account will show at any time the liability on outstanding coupons. If there are several bond issues, an Interest Payable account might be set up for each.

Assuming that all of the bond coupons were paid by the company on the due date, we have the following entry:

July 1, 1916

Bond Interest Payable.....	\$25,000	
To Cash.....		\$25,000
For interest coupons presented and paid this day.		

At the end of each year, if not oftener, the Bond Interest account should be closed into Profit and Loss or into such other account as the system in use may call for.

§ 227. Interest on Registered Bonds

In the case of registered bonds, interest checks are usually sent by the treasurer of the company direct to the holders, though not infrequently the checks are sent by the fiscal agent. They are usually mailed so as to reach the payees on the date when the interest is due or as soon as possible thereafter. The book entries for accruing and paid interest on registered bonds do not differ from those required and illustrated for interest on coupon bonds. An alphabetical list of the registered bondholders entitled to receive interest checks must be prepared for each interest period.

§ 228. Bond Interest Accrued Monthly

Nearly all large corporations require monthly statements of income and operating expenses and statements of condition, so that it becomes necessary at the end of each month to compile the various expenses belonging to that period. These expenses obviously comprise not only the current expenses and pay-roll, but a proportionate share of prepaid and accruing charges, as interest, discount, taxes, insurance, etc. Bond interest is generally payable half-yearly, so that each monthly statement should include one-sixth of the half-yearly fixed interest

charge. As an offset to each monthly interest apportionment, a corresponding credit is set up to "Accrued Bond Interest," or "Accrued Interest Coupons," or "Accrued Bond Coupons," or some other account that will clearly designate the interest obligation. Such entries are made through the journal. For example, referring to the previous illustration, if the half-yearly bond interest of \$25,000 is to be accrued in monthly proportions, an entry is required at the end of each month as follows:

January 31, 1916		
Bond Interest.....	\$4,166.67	
To Bond Interest Accrued.....		\$4,166.67
Accrual of interest on \$1,000,000 of 5% bonds for month of January.		

A similar entry should be made at the end of each succeeding month. A like entry is necessary for registered bond interest, and for interest on any other bond or mortgage obligation, and even for interest accruals on current liabilities. Monthly entries are necessary also for interest accruing on investments and receivables, especially when monthly statements are required.

At the end of each six months the bond interest is paid, Cash being credited, and the "Bond Interest Accrued" account closed by the corresponding debit; but whether or not the "Bond Interest" account is closed at the same time depends on the closing dates adopted by the company. As a rule, it remains open until the end of the fiscal year, though at any time during the year it shows the cumulative total for all of the months as well as the interest for each month. Sometimes the ledger accounts are closed monthly, in which case the Bond Interest account is closed into Profit and Loss twelve times a year.

§ 229. Interest on Two or More Bond Issues

Definite examples of entries to fit all bond interest conditions cannot well be given. Those already given, with those which follow, illustrate their general character and are in accordance with the entries employed by many of the larger corporations. Each entry must indicate for what purpose it was made and the conditions involved. Monthly entries are made for accruing bond interest on the various bond issues and for the several series of any particular issue. An account is opened for each separate obligation as a rule, and sometimes for each part issue thereof.

As a basis for the entries which follow, assume that January 1, 1916, first mortgage 5% bonds are issued for \$2,000,000, interest payable April 1 and October 1; also first and refunding 6% mortgage gold bonds for \$4,000,000, interest payable January 1 and July 1. At the end of June, the following entry is necessary to record the interest accruals for the month, similar entries having been made for the intervening months.

June 30, 1916

Interest on Funded Debt.....	\$28,333.34	
To Accrued Interest on Bonds.....		\$28,333.34
Monthly interest accrual on outstanding bonds as follows:		
	Bonds Outstanding	Accrued Interest
First mortgage		
5% bonds...\$2,000,000.00		\$8,333.34
First and re-		
funding 6%		
bonds 4,000,000.00		20,000.00
	\$6,000,000.00	\$28,333.34

When several series of bonds are outstanding, it may

be advisable to open an interest account for each series, as "Accrued Interest on Bonds—Series A," "Accrued Interest on Bonds—Series B," etc. Of course, in a book-keeping system where the voucher is in use, a journal voucher would be made out for the above entry, giving full details respecting the interest applications, as "Accrued Interest on First Mortgage 5% Bonds," and "Accrued Interest on First and Refunding 6% Mortgage Bonds."

Since the coupons of the first and refunding mortgage 6% bonds are now due, an entry is made setting up the liability for the particular coupon and closing off the portion of interest accrued to date, thus:

June 30, 1916	
Accrued Interest on Bonds.....	\$120,000
To Bond Coupon No. 9, Due July 1, 1916 (A Co. 6's).....	\$120,000
For six months' interest due July 1, 1916, on \$4,000,000 of first and refunding 6% gold bonds.	

An entry similar to the above is required each time the coupons on any particular bond issue fall due. At the same time a check is issued to the financial agent for redemption of the coupons No. 9 as they mature. The entry is:

The Globe Trust Company, Trustee.....	\$120,000
To Audited Vouchers (or Cash).....	\$120,000
For payment of six months' interest due July 1, 1916, on \$4,000,000, etc.	

It will be seen now that all No. 9 coupons are standing on the ledger as a liability and so remain until paid, no matter how long that may be; also that there is a corresponding charge to the trustee for an equivalent amount.

The trustee renders a report at the end of each month, setting forth the amount and number of coupons paid to date, all of which are turned over to the company for cancellation. At that time an entry is made for as many coupons as may have been paid. For illustration we will assume that \$84,800 of the above amount has been presented and paid, requiring this entry:

July 31, 1916

Bond Coupon No. 9, Due 7/1/16 (A Co. 6's)	\$84,800
To The Globe Trust Company, Trustee . . .	\$84,800
For interest coupons paid by The Globe Trust Company, Trustee, during the month of July, 1916, as per statement rendered.	

If more than one class of coupons were paid, they would also be debited in like manner. For the first mortgage 5% bonds, similar entries are required at the end of September. At the end of the fiscal year or half-year, the account for the interest on bonds must, of course, be closed into Profit and Loss. At that time Bond Interest accounts for any and all issues or series, whether accrued for the full year, or only for one month, must be closed off.

§ 230. Interest on Treasury Bonds

Treasury bonds (see § 176), for the present consideration, are understood to comprise the issuing company's own bonds which have been acquired by purchase or donation. This ownership, so long as the bonds have not been cancelled, makes no difference in the manner of handling or accruing bond interest payable. The monthly accruals are set up as usual, and the interest check handed over to the paying bank at the proper date, while the bank in turn cashes the bond coupons presented for pay-

ment, regardless of ownership or of the sources from whence they come. The issuing company, on the other hand, treats the treasury bonds as investments, the same as bonds of other companies, and collects the income therefrom in like manner. In case monthly accruals of \$10,000 income from treasury bonds and other investments are required to be set up, an entry should be made at the end of each month about as follows:

January 31, 1916

Accrued Income from Investments.....	\$10,000	
To Income from Investments.....		\$10,000
For accrued income on investments for one month, as follows: (Recite the amount, rate, etc.)		

If it is desired that the income from treasury bonds be kept separate from that of other investments, debit Accrued Income from Treasury Bonds and credit Income from Treasury Bonds.

As the cash is received in payment the following cash book entry is required on the due date:

July 1, 1916

Cash	\$60,000	
To Accrued Income from Investments....		\$60,000
For cash income on investments due today as follows: (Recite details of investments.)		

At the end of each fiscal period the Income from Investments account is closed to Profit and Loss as follows:

December 31, 1916

Income from Investments.....	\$120,000	
To Profit and Loss (or Income).....		\$120,000
To close into Profit and Loss, being total income for the year from investments.		

If income is derived from several disconnected sources, it might be advisable to open separate accounts to distinguish them from one another, as Income from Bonds, Income from Real Estate Investments, Income from Dividends, etc.

§ 231. Interest on Guaranteed Bonds

Interest payments on guaranteed bonds are handled in the same manner as those of any other class of bonds. The issuing company pays the interest in the usual way if it is able. In case it is unable to do so, the guaranteeing company must make the payment, which must obviously be considered an advance to the subsidiary company, to be repaid at some future date. At the time of the advance, a cash book entry should be made as follows:

Advances to Subsidiary Company (giving name of company).....	\$25,000	
To Cash.....		\$25,000
For payment of interest due this day on \$1,-000,000 of guaranteed 5% bonds of The		Company.

On the books of the issuing company the following entry is required:

Bond Interest (or Bond Interest Accrued).....	\$25,000	
To Advances from	Company	\$25,000
(Full explanation here.)		

The entries may, of course, be very different from those shown, depending upon the agreement existing between the two companies; but in any case the matter should be clearly set forth in each company's books.

§ 232. Interest on Income Bonds

Since income bonds are to all intents and purposes

the same as preferred stock, it is manifest that the book entries for the interest thereon would be practically the same as those required for dividends when declared. As in the case of stock, interest on income bonds can be paid only when the company's profits are sufficient to justify such payment; therefore, as a rule no entry is necessary or advisable until the directors decide whether or not it shall be paid. On the other hand, when it is practically assured that the interest coupons will be paid, monthly entries for accruing interest are in order. Income bonds generally contain half-yearly coupons, though their payment, of course, is contingent upon the company's earnings. When declared at the interest date the following entry is made:

December 31, 1916		
Interest on Income Bonds.....	\$25,000	
To Interest Payable on Income Bonds....		\$25,000
For interest at 5% on income bonds for six months, declared by the directors and payable January 1, 1917.		

The Interest account is closed into Profit and Loss. Note that instead of the word "interest," we might use the word "dividend." When the interest is paid, the cash entry should be as follows:

January 1, 1917		
Interest Payable on Income Bonds.....	\$25,000	
To Cash.....		\$25,000
For payment of interest on income bonds.		

§ 233. Interest on Special Bond Issues

The principles already stated for the entry of bond interest apply in handling the interest on all other bond issues where registered and coupon bonds are used,

whether secured or otherwise. Profit-sharing or participating bonds require extra entries for setting aside the share of profits apportioned to them, which in turn would be paid by check or otherwise, as the case might be.

§ 234. Interest Charged to Construction

The Interstate Commerce Commission and the various state public utility commissions permit the capitalization of various charges during periods of construction. This principle might apply equally as well to corporations not under commission regulation, so long as the charges capitalized are actual and legitimate and expended during the construction of plant, or extension of property and equipment. Real estate development companies and other similar enterprises generally include certain "loading" charges as part of the development or construction cost. Such charges may include development expenses, interest on bonds and loans, legal and other direct expenditures, proportion of bond discount, etc. These items are usually charged to the appropriate accounts; and then at the end of the year, or upon completion of the construction, a transfer entry is made to place them in the Construction account—or to such other account as may be proper.

The following entry shows the manner in which such transfers should be made:

December 31, 1916		
Construction Account (or Plant and Equipment)	\$42,000	
To Construction Expenses.....		\$20,000
" Bond Interest.....		10,000
" Loan Interest.....		4,000
" Bond Discount.....		8,000
To close above accounts into Construction account, being all of the construction expenses and interest, and the proportionate amount of the bond discount for the period.		

Many corporation officials advocate the addition of all bond discount and expense to plant account, especially if the bond issue was created for extension of the plant; but this is not good practice, since the manufacturing account through depreciation charges would eventually be made to bear a considerable portion of the expense of financing the company.

§ 235. Income from Investments

Income from investments other than treasury bonds is handled in the same manner as explained above. Dividends from stock investments, however, should not be entered as accrued monthly income, or entered in any other way until the dividend has actually been declared.

A plan of entering income from investments that differs slightly from the one suggested under "Interest on Treasury Bonds" is given below. Assume that Company A owns \$1,000,000 of Company B's 6% bonds, payable January 1 and July 1. At the end of each month the following entry should be made on Company A's books for the accrued income:

January 31, 1916

Accrued Interest on Bonds Owned.....	\$5,000	
To Interest on Bonds Owned.....		\$5,000
(Full explanation here.)		

At the regular interest dates, July 1 and January 1, or in fact the day preceding, the following entry should be made:

June 30, 1916

Company B.....	\$30,000	
To Accrued Interest on Bonds Owned....		\$30,000
(Full explanation here.)		

When the bond coupons are presented to the paying bank and the cash received therefor, the following entry is required:

July 1, 1916		
Cash	\$30,000	
To Company B.....		\$30,000
(Full explanation here.)		

It is apparent, of course, that this could be handled very differently so long as it records the matter adequately and clearly. The debit in the first entry might be to Accrued Interest Receivable or Accrued Interest on Bonds Receivable. The second and third entries could be consolidated into one, debiting Cash and crediting Accrued Interest on Bonds Owned.

CHAPTER XIX

BOND DISCOUNT AND PREMIUM

§ 236. Bonds Sold Above or Below Par

When bonds are sold, the standing of the issuing company and its ability to pay all obligations at maturity have, of course, a direct and important bearing on the price secured. A strong, well-managed corporation may be able to sell a $4\frac{1}{2}\%$ or 5% bond near to or above par, while another company not so well known or not so strong financially may be unable to sell a 6% bond save at a considerable discount.

For instance, the issue of \$49,000,000 consolidated mortgage $4\frac{1}{2}\%$ gold bonds of the Pennsylvania Railroad Company, dated February 1, 1915, due in 1960, was offered through a prominent banking house of New York and promptly taken up at $103\frac{3}{4}$ and over, and accrued interest to date of delivery. At this price the investor got but little over $4\frac{1}{3}\%$ on his investment, but the undoubted stability of the company, its careful management, and the ready market for the bonds in case the investor should wish to sell, made them very attractive. Also, the fact that these bonds were a legal investment for savings banks in several states, and, by agreement of the company, free from taxation under present or future laws of the State of Pennsylvania or of the United States, added to their desirability.

On the other hand, April 1, 1916, the Chesapeake and Ohio Railway Company issued \$40,180,000 of 5% con-

vertible thirty-year secured gold bonds, carrying many desirable features. These were debenture bonds offered also through a strong New York banking concern, but they sold at approximately 95 with interest to date of sale.

In both of these cases the bankers through whom the bonds were sold were of undoubted strength, and the difference in price clearly reflected the relative desirability of the bonds from the standpoint of the investor. In the case of the Pennsylvania bonds, every desirable feature was present. In the case of the Chesapeake and Ohio bonds, the preceding financial history of the road had an adverse influence and the general conditions under which the bonds were issued were not as satisfactory as in the case of the Pennsylvania bonds. As a result, the Pennsylvania bonds sold at a premium of $3\frac{3}{4}\%$ and over, and the Chesapeake and Ohio bonds at a discount of approximately 5%.

§ 237. Bonds Sold Between Interest Dates

When bonds are sold at other than the regular interest dates, allowances must, of course, be made for accrued interest in determining the price actually received for the bonds. For instance, a bond bearing interest at the rate of 6% per annum, payable semiannually, January 1 and July 1, must receive its 3% on the interest date regardless of when it was sold. If, then, such a bond were sold March 1, interest has accrued to the amount of 1%, and this must be deducted from the amount received to determine the real price of the bond. If the amount received for the bond were 103, it is obvious that 1% on the face of the bond must be allowed for the accrued interest, and this being deducted leaves 102 as the price actually received for the bond.

If the bond were sold for 100, there would obviously be a discount of 1% on the transaction, the actual price of the bond being 99.

§ 238. Expenses of Bond Issue

Many authorities consider the expenses incurred in the floating of a bond issue as directly chargeable to the cost of the issue, in the same manner as discount on the bonds. The Public Service Commission of the First District of New York includes among such expenses the following: "All expenses connected with the issue and sale of evidences of debt, such as fees for drafting mortgages and trust deeds, fees and taxes for recording mortgages and trust deeds, cost of engraving and printing bonds, fees paid trustees provided for in the mortgages and trust deeds, fees and commissions paid underwriters and brokers for marketing such evidences of debt, and other regular expenses."

§ 239. Entries for Bond Discount and Expense

To illustrate the disposition to be made of discount on bonds and the other expense inevitable in connection with a bond issue, we will assume that the bond issue of \$1,000,000 of the Lenox Iron Works was sold for cash at 90 flat, and that expenses incurred in connection with the issue amounted to \$5,000. The bond discount may be charged under "Discount on Bonds" or some other suitable title, and the expense, to "Expense of Bond Issue"; or both the discount and expense may be charged to one account, as "Bond Discount and Expense." The entry for the sale is:

January 1, 1916		
Cash	\$900,000	
Bond Discount and Expense.....	100,000	
To Unissued First Mortgage Bonds...		\$1,000,000
For entire issue of first mortgage 5% bonds sold to bankers at 90.		
Bond Discount and Expense.....	\$5,000	
To Cash.....		\$5,000
For bond issue expenses paid in cash.		

§ 240. Entries for Bond Premium

Premium received on the sale of bonds is credited to a distinguishing account, as "Premium on Bonds," "Bond Premium," or "Premium and Discount on Bonds." Assuming that the issue of \$1,000,000 bonds of the Lenox Iron Works sold at a premium of 2%, the following entry would be made:

January 1, 1916		
Cash	\$1,020,000	
To Unissued First Mortgage Bonds..		\$1,000,000
" Premium on Bonds.....		20,000
(Full explanation here.)		

§ 241. Nature of Bond Premium and Discount

The entries required to bring bond premium or bond discount upon the books are simple. After they are brought upon the books, their proper treatment is a more difficult problem.

The premium or discount which is either received or given upon the sale of the bonds may be said to represent a deduction from, or an addition to, the interest paid on the bonds. In other words, "Premium or discount on bonds is a deduction from, or addition to, the nominal rate of interest which the bond carries; that is to say, there is a rate known as the true or effective rate, at which any corporation can place its bonds at par; if it elects to place them at any other rate, the bonds will sell at a premium or discount as the case may be; but the effective rate remains the same and this effective rate is the proper charge to Income account. Hence, the premium or discount should theoretically be spread over the term of the bonds, and the annual instalment thereof credited or charged to the Income account each year."*

*"Accounting Practice and Procedure" by A. Lowes Dickinson, page 134.

§ 242. Treatment of Bond Premium and Discount

As already stated, bond premium or discount is from its very nature a deduction from, or an addition to, the cost of the funds raised by the issue. It therefore really decreases or increases the amount of nominal interest paid during the life of the bonds.

In order that each accounting period may show accurately the true cost of carrying the issue, the premium or discount must be written off over the life of the bonds and credited or charged periodically to the interest account and through this to Profit and Loss.

Some organizations with a large surplus make a practice of writing off the Bond Discount and Expense account immediately, but this does not show the true cost of carrying the issue and is therefore misleading. Other organizations write off the discount in several instalments, but this is not accurate and is as objectionable as the practice of charging it off immediately.

Bond premium is, much more frequently than discount, thrown immediately into the profit and loss or surplus accounts. This practice is, of course, just as misleading as the same method of handling a discount would be, for it will result in an erroneous statement of the operating costs.

§ 243. Effective Rate Method

The best modern practice of handling either bond premium or discount is that known as the effective rate method, this effective rate being figured on the amount actually received for the bond, and not on its par. Under this method the effective rate which the issue bears is charged against Income as the Accrued Interest account is set up. In the case of discount, the effective rate is debited to the Interest account and the nominal rate credited to Accrued Interest, while the difference between the nominal and

effective rates is credited to Bond Discount and Expense. In the case of premium, the difference between the effective and nominal rates is debited to the Premium account.

To illustrate the handling of premium or discount accounts on the books under the effective rate method, let us assume that the \$1,000,000 issue of the Lenox Iron Works which sold at 90 flat, and the expenses of which were \$5,000, runs for twenty years and bears interest at the rate of 5% per annum, payable annually. The total of the Discount and Expense account shows \$105,000 that must be written off over the life of the bonds. Instead of the nominal rate of 5%, or \$50,000, which the issue carries, the true or effective rate would be 6.139% or \$55,250. At the end of the first year, if monthly entries are not made, the entries recording this would be:

Interest on Bonds.....	\$50,000	
To Accrued Interest.....		\$50,000
Interest accrued on the issue of \$1,000,000 first mortgage 5% bonds.		
Interest on Bonds.....	\$5,250	
To Bond Discount and Expense.....		\$5,250
Difference between the nominal and true effective rates on the \$1,000,000 bond issue.		
Accrued Interest on Bonds.....	\$50,000	
To Cash.....		\$50,000
Payment on accrued interest on \$1,000,000 bond issue.		

The interest is eventually closed into Profit and Loss by the following entry:

Profit and Loss.....	\$55,250	
To Interest on Bonds.....		\$55,250
Transfer of the effective interest on \$1,000,000 bond issue to Profit and Loss.		

The entries for bond premium would, of course, be of the same general nature, the effective rate, however, being less than the nominal or accrued interest charged.

Where the bonds are to be redeemed at maturity at par, the problem of writing off the interest or discount is, as has just been shown, comparatively simple; but where they are to be redeemed at prices other than par, and at varying dates of maturity, the problem is much more complicated. The whole matter is summed up admirably in the quotation given below.*

§ 244. Varying Conditions Affecting Annual Charge

"In accounting for the charge to income where the effective interest method is adopted, these cases must be considered:

"(a) Bonds issued at a discount and redeemable at par. When the bonds are first issued the full par value would be credited to the liability account, while the difference between this full value and the cash received would be charged to a discount on bonds account. The full effective rate of interest would be charged to Income account, while so much of it as represents the nominal interest would be credited to Interest Accrued, and the balance to Bond Discount, thus gradually reducing this account over the life of the bonds.

"(b) Bonds issued at a premium and redeemable at par. The conditions are exactly the reverse of case (a). Discount on Bonds account will become Premium on Bonds account with a credit balance; the effective interest charge will be less than the actual, leaving a charge to Bond Premium account in reduction of the balance on that account.

"(c) Bonds issued at par, redeemable at a premium. This case is in substance identical with (a), but in practice

*By permission, from "Accounting Practice and Procedure" by A. Lowes Dickson, pages 135-141.

the treatment is different, as there is neither discount nor premium at the date of issue. The charge to Income account will exceed the interest accrued, and the difference will be credited to Bond Premium account and accumulated there until final redemption, all premiums paid on redeemed bonds being charged to this account.

“(d) Bonds issued at a discount and redeemable at a premium. This combines cases (a) and (c). The excess of the effective rate will be credited to Premium and Discount account, and will gradually convert the debit balance on that account into a credit sufficient to equal the amount of all premiums payable on final redemption.

“In practice it is often found that bonds are purchased in the market at prices varying from, and generally less than, the specified redemption prices, and then transferred to the trustees of the sinking fund at the specified prices, and a saving thus effected which must be taken into account when determining the annual charge to income. Or, again, the redemption dates may be anticipated for a whole or part of the issue, and further disturbing factors thus introduced.

“The saving on the purchase of bonds in the market at prices below those fixed for redemption, may be dealt with in one or the other of the following methods:

1. Credit the amount to Income account each year, thus finally disposing of it.
2. Credit the amount to Discount (or Premium) on Bonds account, thus eventually producing a surplus on this account, which would ultimately be transferred to Income account.

“Neither of these methods is theoretically accurate; but in view of the impossibility of determining what the market price will be in the future, theoretical accuracy is impossible.

“The treatment in the case of anticipation of redemption

dates is a more difficult matter, for, if carried out on at all a large scale and not accompanied by an equitable reduction on the redemption price, the effective interest rate will be materially increased. The only sound method would appear to be to recalculate the effective rate on the basis of the bonds still outstanding and the new redemption terms. If this is not done, there may be a considerable shortage to make up at the date of final redemption. This fact is frequently overlooked, although it should be recognized as an important factor, particularly in any refunding or redemption plan.

§ 245. Methods of Determining Charge to Income

"There are various methods in use for determining the proper interest charge to be made to Income account under the various conditions that arise.

"The first and most correct method, which may be called the effective interest method, consists in charging to Income account the effective interest rate calculated from the known conditions of issue upon the whole amount outstanding during the year, with an addition or deduction of an amount equal to the excess or deficit of the amount paid for redemption during the year as compared with the fixed amount provided. For instance, if the conditions of the issue provided that \$100,000 of bonds be retired during the year at 105, and as a matter of fact they are purchased at 95, the true interest on the bonds bearing interest during the year would be reduced by \$10,000, representing the saving on bonds retired during the year as compared with the price therefor assumed in determining the effective rate. The tendency of this method would probably be to increase gradually the annual charge to Income for interest and sinking fund until the limit price of redemption was reached; for, as the amount of the bonds outstanding diminished, the market price might be expected to rise.

“The second and more common method, which may be called the equal instalment method, is to ignore altogether the effective interest rate; to charge to Income account each year the interest actually paid, together with a proportionate part, according to the whole term of issue, of the discount on issue or premium on redemption; Income account being also credited with any savings made by purchase of bonds in the market.

“A third method, which may be called the bonds outstanding method, and which may be safely adopted where, by reason of complication in the terms of issue and redemption, it is difficult or impracticable to determine the true interest rate, is to distribute the discount or premium over the period in the proportion that the bonds outstanding for each year bear to the sum of the bonds outstanding for all years of the currency of the loan. Any saving made by the purchase of bonds in the market is credited to Income account.

“When a large accumulated surplus is available, the practice is frequently adopted of charging the whole discount on issue to Profit and Loss account, taking up any profit or loss on subsequent redemption at a discount or premium to the credit of Profit and Loss account as it arises, and leaving the nominal interest of the bonds actually outstanding each year as the only charge to Income account. A great objection to this practice is that thereby the true rate of interest paid on loans during their currency is entirely lost sight of; current fixed charges against earnings are understated; and the portion representing the discount is charged against surplus arising out of previous operations, instead of being charged against income from current operations which should meet it. Any savings on bonds which are purchased in the market are a credit to Income account.

§ 246. Operation of the Various Methods of Determining Annual Charge to Income

"In order to show the effect of these various methods, it may be well to consider a specific case as follows:

"An issue of \$1,000,000 of bonds is made at 90, carrying interest at 5%, and redeemable at the rate of \$50,000 each half year, at 100 for the first five years, and thereafter at 105. Calculations made on these premises show that the effective rate of interest is approximately $8\frac{3}{16}\%$. Bonds are redeemed each as specified, but they are purchased in the market at the following prices, viz.:

1st year.....	92
2nd year.....	93
3rd year.....	95
4th year.....	97
5th year.....	98
6th year.....	100
7th year.....	102
8th year.....	104
9th and 10th drawn at.....	105

"The tables that follow give all the essential figures.

"In the table on page 277, the last four columns show the charges to Income account on the basis (5) of the effective interest method; (6) of the equal instalment method; (7) of the bonds outstanding method; and (8) of charging all discount and premium to surplus; in each case crediting to Income account the surplus arising from purchasing bonds at less than the fixed redemption price.

"If the latter be credited direct to surplus, or carried in the Bond Discount account until all discount has been written off by the operation of these credits and the balance of the effective rate, then, at the end of the 11th half year in the first case and at the end of the 15th half year in the

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Period ½ Year	Payments for Interest at 5% p. a. (a)	Discount provided for (2) — (1)	Surplus on purchase at less than redemption price	Charge to Income on effective interest method	Charge to Income on equal annual Instalment Method	Charge to Income when Discount written off on Bonds outstanding method	Charge to Income when Discount charged to Profit and Loss Account
1	\$25,000.00	\$11,843.75	\$4,000.00	\$32,843.75	\$27,250.00	\$32,905.00	\$21,000.00
2	23,750.00	11,251.56	4,000.00	31,001.56	26,000.00	31,060.00	19,750.00
3	22,500.00	10,659.38	3,500.00	29,659.38	25,250.00	29,714.00	19,000.00
4	21,250.00	10,067.19	3,500.00	27,817.19	24,000.00	27,869.00	17,750.00
5	20,000.00	9,475.00	2,500.00	26,975.00	23,750.00	27,024.00	17,500.00
6	18,750.00	8,882.81	2,500.00	25,132.81	22,500.00	25,179.00	16,250.00
7	17,500.00	8,290.63	1,500.00	24,290.63	22,500.00	24,333.00	16,000.00
8	16,250.00	7,698.44	1,500.00	22,448.44	21,000.00	22,488.00	14,750.00
9	15,000.00	7,106.25	1,000.00	21,106.25	20,250.00	21,143.00	14,000.00
10	13,750.00	6,514.06	1,000.00	19,264.06	19,000.00	19,298.00	12,750.00
11	12,500.00	5,921.88	2,500.00	15,921.88	16,250.00	15,952.00	10,000.00
12	11,250.00	5,329.69	2,500.00	14,079.69	15,000.00	14,107.00	8,750.00
13	10,000.00	4,737.50	1,500.00	13,237.50	14,750.00	13,262.00	8,500.00
14	8,750.00	4,145.31	1,500.00	11,395.31	13,500.00	11,417.00	7,250.00
15	7,500.00	3,553.12	500.00	10,553.12	13,250.00	10,571.00	7,000.00
16	6,250.00	2,960.94	500.00	8,710.94	12,000.00	8,726.00	5,750.00
17	5,000.00	2,368.75	.....	7,368.75	11,250.00	7,381.00	5,000.00
18	3,750.00	1,776.56	.....	5,526.56	10,000.00	5,536.00	3,750.00
19	2,500.00	1,184.38	.....	3,684.38	8,750.00	3,690.00	2,500.00
20	1,250.00	1,232.80	.....	2,452.80	7,500.00	1,845.00	1,250.00
(c) Extra							
		\$125,000.00	\$34,000.00	\$353,500.00	\$353,500.00	\$353,500.00	\$228,500.00
		1/20th = \$6,250.00					

- (a) Interest at 2½% for each half year on \$1,000,000, less \$50,000 each half year.
 (b) Interest at 4 3/32% for each half year on \$900,000, less \$45,000 each half year.
 (c) Balance due to approximation in effective rate.

second, the discount will be extinguished and thereafter only the actual interest paid, less surplus on market purchases, will be charged to Income.

§ 247. Determining Annual Charge When Proportionate Discount Is Written Off

"The charge to Income account on the bonds outstanding method is arrived at as shown in the following table. It is so close to that given by the effective interest method that for all practical purposes it may safely be adopted.

Period ½ Year	Bonds Outstanding	Proportion of Outstanding Bonds to total Bonds	Amount of Discount Instalment	Interest Payment	Profit on Bond Purchase	Annual charge to Profit and Loss
1	\$1,000,000	100/1050	\$11,905	\$25,000	\$4,000	\$32,905
2	950,000	95/1050	11,310	23,750	4,000	31,060
3	900,000	90/1050	10,714	22,500	3,500	29,714
4	850,000	85/1050	10,119	21,250	3,500	27,869
5	800,000	80/1050	9,524	20,000	2,500	27,024
6	750,000	75/1050	8,929	18,750	2,500	25,179
7	700,000	70/1050	8,333	17,500	1,500	24,333
8	650,000	65/1050	7,738	16,250	1,500	22,488
9	600,000	60/1050	7,143	15,000	1,000	21,143
10	550,000	55/1050	6,548	13,750	1,000	19,298
11	500,000	50/1050	5,952	12,500	2,500	15,952
12	450,000	45/1050	5,357	11,250	2,500	14,107
13	400,000	40/1050	4,762	10,000	1,500	13,262
14	350,000	35/1050	4,167	8,750	1,500	11,417
15	300,000	30/1050	3,571	7,500	500	10,571
16	250,000	25/1050	2,976	6,250	500	8,726
17	200,000	20/1050	2,381	5,000	...	7,381
18	150,000	15/1050	1,786	3,750	...	5,536
19	100,000	10/1050	1,190	2,500	...	3,690
20	50,000	5/1050	595	1,250	...	1,845
	<u>\$10,500,000</u>		<u>\$125,000</u>	<u>\$262,500</u>	<u>\$34,000</u>	<u>\$353,500</u>

CHAPTER XX

SINKING FUNDS

§ 248. Function of the Sinking Fund

A fund is always an asset. A sinking fund is a reservation of assets, usually cash, set aside periodically for a specified purpose and placed in the hands of a trustee for safe-keeping until the date arrives for its expenditure in accordance with the purpose for which it was created.

The sinking fund is resorted to as a convenient method of accumulating funds for various purposes, as for the redemption of bonds, the cancellation of a lease, the replacement of some fixed asset, as a plant or a costly machine, or the replacement of an investment in some wasting property, as oil wells, quarries, or mines. When the sinking fund is used in connection with the depreciation of mines, it is frequently spoken of as an "extinguishment fund."

The most common use of the sinking fund in corporation affairs is for the redemption of bond issues, and for this reason the present discussion of sinking funds is confined to the fund for the redemption of bonds.

There are some objections to the sinking fund as a method of accumulating funds, since it withdraws and holds at a nominal rate of interest current cash that could be used more profitably in the business. The fund at the best can hardly earn more than 4% or 5%, while invested in the business it should be made to earn 10% or more.

The sinking fund must, of course, be made to earn as much as possible during the period of its reservation, and to that end it is usually deposited in a savings bank, at

interest, until the opportunity arises for investment in high-grade interest-bearing securities. The manner in which the sinking fund shall be invested is usually set forth in the trust deed or other instrument through which the sinking fund is brought into existence.

§ 249. Creation of the Sinking Fund

The manner of creating the sinking fund is usually set forth in the trust deed. Some of the various methods followed in the maintenance of sinking funds are as follows:

Cash instalments, paid to the trustee half-yearly or yearly, are either deposited in savings banks or invested in approved gilt-edged securities. Sometimes the trustee is permitted and may even be compelled to invest in bonds of the issuing company, usually with definite instructions as to whether the purchased bonds shall be cancelled or kept alive as a sinking fund investment. Frequently it is provided that the first payment to the sinking fund need not be made for two or more years after the issuance of the bonds, so as to give the company time to "get its breath" before beginning the process of redemption.

The sinking fund instalments may be composed of definite amounts, as \$20,000, \$50,000, \$100,000, or more, as the case may be, proportioned to the amount and time of the bond issue; or they may vary from year to year, being either a given per cent of the outstanding bonds, or a given per cent of the gross business of the company, or a given proportion of the gross profit or net profit.

In the case of a mine or quarry the instalments may either be definite amounts, as stated above, or else based upon the output of ore—as 12 cents per ton for every ton of ore mined, 10 cents for every square yard of stone quarried, etc.

In the case of timber companies the instalments may be

based upon the quantity of timber cut, being so much on every thousand feet of timber. With real estate development companies the sinking fund payments are frequently governed by the number of lots or divisions plotted or the progress attained in improving the property.

In this connection it may be of interest to review some of the sinking fund methods used by well-known corporations.

The first mortgage 5% sinking fund 30-year gold bonds of the Baldwin Locomotive Works contain the following provisions respecting the sinking fund :

"Beginning with the year 1915 there will be an annual sinking fund payment of 2% per annum on the maximum amount of bonds which shall at any time be issued. Bonds for the sinking fund are to be purchased at a price not exceeding 107 1/2% and accrued interest, or drawn by lot at that price."

A subsidiary of the Erie Railroad Company issued \$6,000,000 of first mortgage 6% sinking fund gold bonds, and the mortgage indenture requires a cumulative sinking fund sufficient to retire at least \$2,377,000 bonds before maturity. The sinking fund clause calls for a deposit of \$20,000 April 1, 1916, and annually thereafter, this fund being applicable to the purchase of the outstanding bonds upon tenders by bondholders at not exceeding 110 up to and including the year 1920, and at 115 thereafter prior to maturity. If not obtainable at these prices, bonds may be called by lot at corresponding prices upon the succeeding first day of July. The redemption price stated is noticeably high, especially since it is the usual practice of railroad companies to issue refunding bonds.

Article three of the trust deed of the United States Steel Corporation is specific as to the sinking fund provisions and the manner of investing the funds by the trustee.

Annual deposits to the fund were begun the year following the bond issue. Some of the provisions are as follows:

"On or before the 1st day of April, 1904, and annually on or before each first day of April thereafter until all the bonds hereby secured shall have been acquired for the sinking fund under this article, or shall have been redeemed as herein provided, or shall have been paid or satisfied, the Steel Company will pay to Messrs. J. P. Morgan & Co., hereby appointed Sinking Fund Trustees, or to their successors in trust, the sum of \$1,010,000. All sums so received by the Sinking Fund Trustees, together with the accretions thereto as hereinafter provided, shall constitute a sinking fund for the redemption of the bonds hereby secured, and shall be held, used, and applied as hereinafter provided.

"All bonds hereby secured that shall be purchased by the Sinking Fund Trustees or be redeemed, as hereinafter provided, by use of moneys in the sinking fund, shall be deemed to remain alive for the purpose of such sinking fund; and semiannually the Steel Company shall pay to the Sinking Fund Trustees the interest on all such bonds of the Steel Company held by the Sinking Fund Trustees for the purpose of such sinking fund.

"All moneys received by the Sinking Fund Trustees under this article, including moneys received by the Sinking Fund Trustees from the Steel Company in respect of interest on bonds hereby secured and held for the purposes of the sinking fund, and moneys received for principal or proceeds of, or interest upon, other bonds or obligations held in the sinking fund, and also all interest that may be allowed by the Sinking Fund Trustees upon sinking fund moneys during the deposit thereof with the Sinking Fund Trustees, shall be held by the Sinking Fund Trustee as bankers in general account. . . ."

§ 250. Sinking Fund Created Out of Profits

The deed of trust sometimes requires that a sinking fund "shall be created out of profits." Even where this is done by means of a reserve fund, there is also usually a reservation of actual cash. In this case an amount equal to the cash reservation is set aside out of profits by means of a debit to Profit and Loss and a credit to Sinking Fund Reserve, or to Bond Extension Reserve, or to Debt Extinguishment Reserve.

In the present day the sinking fund reserve is not so often required as part of the scheme of bond redemption. Bonds are not necessarily paid out of profits, and there is no more need of reserving profits for their redemption than for the reservation of profits for the payment of promissory notes or ordinary bank loans. The provision, however, has some merit as it has a tendency to prevent directors from paying dividends with cash that should be placed in the sinking fund or be kept in the business for working purposes. (See § 262.)

When a special sinking fund reserve is created, it has no specific function to perform beyond the mere safeguarding of the profits, and when the bonds are redeemed the account must be closed into Surplus. This results in a sudden and substantial increase of available profits, and the directors may then properly "cut a melon" if they see fit, declaring these excess profits in dividends. This would not impair the capital stock.

§ 251. Safeguarding the Sinking Fund

The sinking fund instalments are usually placed in the hands of a trustee for safe-keeping, this trustee being some reliable trust company, a firm of bankers, or a committee of individuals. Sometimes the corporation itself takes charge of the sinking fund, and in this case the fund is

placed in the care of either the board of directors or a committee of directors.

The sinking fund cash may be deposited by the trustee in one or more reliable savings banks to draw the regular rate of interest, or may be all or partly used for the purchase of high-grade interest-bearing securities such as are legal for investment trust funds. Or, as stated, it may be used, in whole or in part, for the purchase of the company's outstanding bonds either at the market price or at some given price, usually above par. Bonds redeemed are either turned over to the company and by it cancelled, or are held "alive" in the sinking fund as a source of income. (See § 260.)

Sinking fund cash is occasionally invested in other ways, as in real estate mortgages, in building and loan associations, or even in an extension of the company's own properties; any such variations of the usual investments depending upon the provisions of the deed of trust.

§ 252. Adequacy of the Sinking Fund

It will readily be seen that the amount of the sinking fund deposits must be calculated in advance, so that when the bonds mature there will be sufficient cash available for their redemption. In case of shortage for any cause, additional funds must be raised to pay off the maturing bonds. On the other hand, if the required amount has been accumulated prior to the date of maturity, further sinking fund payments may be discontinued unless otherwise provided in the agreement under which the sinking fund is created.

Where definite amounts are set aside yearly, such amounts are generally governed by the aggregate debt outstanding, and by the estimated rate of interest the fund is likely to earn. For example, if it is desired to meet a debt of \$800,000 in twenty years, an annual deposit of \$26,866

to the sinking fund would, at 4% interest compounded annually, provide an adequate cash supply for the purpose, but this presupposes that the trustee will be able to keep the funds continuously invested at this rate. This may not always be possible, and, on the other hand, it is probable that the trustee may be able to secure a better interest rate, particularly if he is permitted to invest in the company's own bonds. It will be seen, then, that the exact earning capacity of trust funds cannot be accurately foretold, and that officials should be governed accordingly in determining the sinking fund instalments.

§ 253. Annuity Method for Sinking Funds

There is a growing tendency to apply scientific annuity calculations to bonds and sinking funds, as well as to amortizing diminishing balances. Under this plan it is assumed that all instalments and interest accumulations to the sinking fund will earn compound interest from year to year, at a given rate, say 3 or 4%. The amount that shall be in the fund at any time is carefully estimated when the bonds are issued, so that at the date of maturity there may be in the hands of the trustee enough to pay the debt. If at any time this estimate falls short, because of a lower earning rate or for any other reason, an adjustment must be made by increasing the annuity or by making a special deposit equal to the existing deficit. When estimating the rate of yield, care must be taken not to use a higher rate than the regular savings bank interest. If, however, the sinking fund trustee invests in the company's own bonds at any time, the income will be materially increased.

§ 254. Calculating Fund Annuities

Annuity calculations may be largely avoided by the use

*For a detailed discussion of the subject see "The Accountancy of Investments," by Charles E. Sprague

of annuity tables, but, notwithstanding this, it is most desirable to have at least a working knowledge of their principles.

An annuity is a definite sum of money paid at regular intervals. For example, an investment of \$1 at 6% per annum, compounded annually, amounts in five years to approximately \$1.33822558. In other words, if the original \$1 were left on deposit in some one bank for five years, and the annual interest of 6 cents withdrawn each year and deposited in another bank at 6% compounded annually, at the end of five years there would be the original \$1 in the first bank and \$.33822558 in the second bank. This latter amount is the result of an annual deposit of 6 cents for a period of five years with the interest accumulations; therefore \$.33822558 is the value at maturity of an annuity of 6 cents for five years at 6%. From this, the final value of any annuity at 6% for five years may readily be found, by dividing \$.33822558 by 6 to find the value of an annuity of 1 cent and multiplying this by the number of cents in the actual annuity. Thus, an annuity of \$1 for five years has a final value of $\frac{$.33822558}{6} \times 100$, which equals \$5.637093.

This plan requires the use of only the ordinary compound interest tables. The process may be stated as follows:

To find the final value of an annuity for a given time at a given rate, first multiply the compound interest on \$1 for the given time at the given rate by 100 and divide by the given rate. This gives the final value of an annuity of \$1. Then the final value of the given annuity is found by multiplying the final value of an annuity of \$1 by the number of dollars in the given annuity.

The following example will illustrate more fully the application of the compound interest method to sinking fund accumulations:

The People's Gas Company on January 1, 1916, issued \$2,000,000 of first mortgage 5% sinking fund gold bonds, payable in twenty-five years, interest payable semiannually. In order to meet the bonds at maturity, such annual sum in cash is to be deposited with a designated trust company as will accumulate, at 4% compound interest during the currency of the obligations, to an amount sufficient to redeem the bonds.

In finding the amount of the yearly annuity payment, we need not consider discount if the bonds should be sold at less than par, nor the expenses of the issue, nor the payment of interest coupons. Bond discount and expense are treated as expense incident to the issue, and as the coupons mature they are paid out of current funds, and the amount charged to Bond Interest, which in turn is closed into the Profit and Loss account. We have therefore to provide only for the payment of the principal sum of \$2,000,000 at the end of the twenty-fifth year.

We find—usually by consulting an annuity table—that \$1 invested annually at 4% compound interest will amount to \$41.64590829 at the end of twenty-five years. If \$1 invested annually for twenty-five years at 4% compound interest will amount to \$41.64590829, then by dividing this value into \$2,000,000—the amount to be accumulated—the quotient is the number of dollars which must be invested each year to amount in twenty-five years, at 4% compound interest, to the desired sum. Carrying out this division we find the required annuity payment to be \$48,023.93.

In ascertaining the amount of a sinking fund annuity, the determining factors are the principal to be accumulated, the time to run, and the rate of interest obtainable.

§ 255. Sinking Fund to Retire Preferred Stock

The sinking fund plan is occasionally adopted for the

retirement of preferred stock. The following quotation has reference to a new issue of preferred stock of a well-known manufacturing corporation:

“A sinking fund has been created out of earnings for the retirement of the preferred stock at not exceeding \$115 per share and accrued dividend, by setting aside \$200,000 from the net profits for the fiscal year ended July 31, 1914, and annually thereafter an amount equal to 2% of the par value of all preferred stock at any time theretofore issued; and if in any fiscal year dividends are paid on the company stock in excess of 7%, the next succeeding preferred stock sinking fund instalment is to be increased by an amount equal to such excess.”

The entries for such a sinking fund would be the same as in the case of a sinking fund for the redemption of bonds.

CHAPTER XXI

SINKING FUNDS (Continued)

§ 256. Sinking Fund Account

The sinking fund, as already stated, is made up of periodical cash payments to the trustee and the interest accumulations; therefore, definite book entries are required at regular periods to record properly the instalments and interest accretions. An account must be opened for the sinking fund, or for the sinking fund trustee, to which shall be debited the various payments and accumulations, with corresponding credits to cash and to sinking fund income. If the trust agreement requires that the sinking fund shall be created out of profits, then an annual reserve equivalent to the sinking fund instalment must be set aside. The fund itself, however, is composed of assets and recorded on the debit side of the ledger, while the Sinking Fund Reserve account is a credit and shown on the credit side. Careful book records must, of course, be kept of all details respecting the sinking fund and any reserves required in connection therewith.

In the case of small companies the sinking fund procedure is often much less formal than in the case of larger companies, and it is not unusual for the whole of the funds to remain in the hands of the directors themselves; but in any case the accounts should be so kept as to show all information that may be required by any of the interested parties respecting the bonds and the sinking funds.

The regulations of the Interstate Commerce Commission provide for sinking fund accounts of railroads, and quota-

tions from these may be of interest to other than railroad accountants. The first quotation prescribes what shall be included in the sinking fund.

"This account shall include the amount of cash, the ledger value of live securities of other companies, and other assets which are held by the trustees of sinking and other funds for the purpose of redeeming outstanding obligations, including such assets so held in the hands of the accounting company's treasurer when the assets are segregated under a distinct fund; also amounts deposited with such trustees on account of mortgaged property sold, the proceeds of which are to be held for the redemption of securities, and the par value of live securities issued or assumed by the accounting company and held in such funds. A separate account shall be kept for each fund. The title of each such account shall designate the obligation in support of which the fund is created."

Railway companies not infrequently create sinking fund reserves also, which, of course, must be set aside out of profits. The Commission's ruling on the subject of the Sinking Fund Reserve account is as follows:

"This account shall include the net balances in accounts to which are credited definite appropriations of income and surplus, whether held in general funds or specifically set aside in the hands of a trustee for sinking and redemption funds. It shall also include income accretions to such funds retained therein."

Income from sinking fund assets is required to be cared for in the manner specified by the Commission, under "Income from Sinking and Other Reserve Funds." To this account are to be credited income accrued on cash securities and other assets belonging to sinking and other reserve funds, such income being included under non-operating income in the company's regular income statement. In

case a Sinking Fund Reserve account is maintained, a definite amount must be set aside out of income by a debit to the account "Surplus Applied to Sinking and Other Reserve Funds" and a credit to "Sinking Fund Reserves." Such amounts are generally set up monthly, but at the end of each year "Surplus Applied to Sinking and Other Reserve Funds" account must necessarily be closed out.

§ 257. Entries for Sinking Fund Instalments

The sinking fund instalments are paid in cash to the trustee, either half-yearly or yearly, or even at greater intervals, according to the requirements of the deed of trust. For illustration, we will assume that the 5% bond issue of the Lenox Iron Works for \$1,000,000 required an annual deposit of \$50,000 to the sinking fund beginning December 31, 1916. This payment will be recorded:

December 31, 1916

Sinking Fund. Trustee.....	\$50,000
To Cash.....	\$50,000
First deposit to the sinking fund for redemption of \$1,000,000 first mortgage 5% bonds due January 1, 1936, as required by trust agreement.	

If there were several bond issues requiring sinking funds, each fund would have a separate account. They should be designated according to the kind and tenor of the bonds, as "Sinking Fund of First Mortgage 5% Bonds of 1925," "Sinking Fund of \$4,000,000 First Mortgage 5% Sinking Fund Gold Bonds of 1940," as the case may require. Sometimes the name of the trustee is included in the caption, as "Security Trust Company, Trustee of Sinking Fund," or "Trustee of Sinking Fund of \$1,000,000 5% Bonds," etc. The title should be sufficiently descriptive to indicate clearly the fund and its purpose.

§ 258. Entries for Sinking Fund Interest

The duty of the trustee being to safeguard properly the sinking fund and to keep it earning, we will assume, in the present instance, that he deposited the funds in the savings bank to draw 4%. At the end of the first year he must make his report to the company, giving the status of the fund and stating the accumulated income thereon, which in this case would be 4% of \$50,000, or \$2,000. Upon receipt of this report the following entry should be made on the company's books:

December 31, 1917	
Sinking Fund Trustee.....	\$2,000
To Sinking Fund Income.....	\$2,000
To record income from sinking fund deposit of \$25,000 for one year at 4%, as per report of the trustee.	

Sinking fund income should be credited to some account that will clearly indicate the sources from which it came, as shown in the above entry. It is manifestly a part of the company's regular income and must sooner or later appear in the Profit and Loss account. The entry for sinking fund income would be:

Sinking Fund Income.....	\$2,000
To Profit and Loss.....	\$2,000
To close sinking fund income, being the total earning for the year as reported by the trustee.	

Under the terms of trust under which the sinking fund was established no mention has been made of the disposition of the income from the fund, but it might be handled in one of three ways, i.e., turned over to the company, retained by the trustee as an addition to the sinking fund, or be applied to lessening the next sinking fund instalment (§ 253). For the present illustration we have adopted the second method

as the entries are more involved. Under the first method the trustee would turn over to the company cash to the amount of the interest or income and the company would debit cash and credit sinking fund trustee.

To illustrate monthly entries showing the accrual of the sinking fund interest, the following have been constructed upon the facts of the preceding material:

Accrued Sinking Fund Income.....	\$166.67	
To Sinking Fund Income.....		\$166.67
Accrued income @ 4% on \$50,000 of cash on deposit in savings bank for one month, 1/12 of \$2,000.		

This entry would be made at the end of each month, and at the end of the year the following entry would be made:

Sinking Fund Trustee.....	\$2,000	
To Accrued Sinking Fund Income.....		\$2,000
Cash collected by sinking fund trustee during the year, being 4% on \$50,000 on deposit at the savings bank.		

§ 259. Entries for Sinking Fund Investments

. Instead of depositing the sinking fund cash in the savings bank, the trustee may find it more profitable to invest it, or a portion of it, in gilt-edged bonds paying a higher rate of interest. In some cases he is required to invest the funds in bonds of other companies, or of the issuing company itself. We will assume, therefore, that on January 1, 1918, the trustee purchases \$100,000 of first mortgage 5% bonds of the United States Steel Corporation at par, interest due January 1 and July 1. No entry need be made on the company's books for this transaction, since the cash used has already been charged to the sinking fund trustee; in other words, he is simply replacing cash assets with an

equivalent amount of securities. If it is desired, however, as is frequently the case, to show the sinking fund investments separately from the sinking fund cash, even though they are in the hands of the trustee, the following would be the procedure:

January 1, 1918

Sinking Fund Investments.....	\$100,000	
To Sinking Fund Trustee.....		\$100,000
For investment by the trustee in 5% bonds of the United States Steel Corporation at par, as per his report of this day.		

An investment in the company's own bonds would be handled in practically the same way.

The sinking fund now contains bonds which will pay interest twice during the year, \$2,500 in cash each six months. If the bonds had been purchased at a premium or discount, another element would have been introduced—that of properly recording such difference.* At the end of the first half-year an entry for income would be required as follows:

July 1, 1918

Sinking Fund Trustee.....	\$2,500	
To Sinking Fund Income.....		\$2,500
For coupons collected on \$100,000 5% bonds of United States Steel Corporation held in the sinking fund, as per report of the trustee. (Full details necessary.)		

If desired this could be handled by monthly entries accruing the income.

At the end of the year, interest will have accumulated on both interest and bonds, requiring the following entry on the company's books:

*For detailed discussion of this subject, see "The Accounting of Investment" by Charles E. Sprague.

December 31, 1918

Sinking Fund Trustee.....	\$2,630	
To Sinking Fund Income.....		\$2,630
For interest accumulations to the fund, as per report of the trustee, as follows:		
Interest at 4% on \$2,000 in bank, one year	\$80	
Interest at 5% on \$100,000 bonds, one half-year	2,500	
Interest at 4% on \$2,500 in bank, one half-year	50	
Total.....	\$2,630	

Another instalment of \$50,000 is due the sinking fund at this time, and is entered as before.

§ 260. Entries for Investment in Issuing Company's Bonds

The trust deed in many cases provides for the redemption of the bonds by the sinking fund trustee, either at the market price or at a fixed price, and he is compelled to carry out such provisions.

In that event he either carries the bonds in the sinking fund as a source of income, or turns them over to the company for cancellation. To exemplify the entries for the purchase of such bonds for sinking fund investment, we will carry the illustration of the Lenox Iron Works a step further, by a purchase on January 1, 1919, of \$50,000 of the company's own bonds at 102 $\frac{1}{2}$.

The entry to be made for this transaction must be governed by the circumstances, not because the bonds are those of the issuing company, but because of the disposition to be made of the \$1,250 premium paid thereon. Three courses are open:

1. No entry need be made on the company's books at all, either for the purchase of the bonds or for the premium paid.

2. An entry may be made at the time, debiting Sinking Fund Investments or some other appropriate account with the cost price of the bonds, and crediting Sinking Fund Trustee with the cost of the bonds, \$51,250; the premium in this case being amortized over the life of the bonds.

3. An entry as in Method 2, but for the par value of the bonds instead of the cost price; in this case the premium must be charged either against Sinking Fund Income, against Profit and Loss, or to an account called "Premium on Sinking Fund Investments." The last named account should then be closed into Profit and Loss or be amortized gradually over the life of the bonds.

The plan of entry to be selected will depend on circumstances. There is a premium of \$1,250 to be recorded in some way, and eventually to be disposed of; and no matter how it is done, the company is the loser of this amount, especially since the bonds are not to be resold but held until maturity and redeemed at par.

Since the bonds so purchased will draw 5%, it may be good policy to pay the premium and then charge it off, all at once, or gradually, against the income on the trustee's books; the trustee deducting same from the amount of income reported to the company. But since the Sinking Fund account on the company's books should represent the true status of the trustee's holdings, it seems advisable to relieve him from any further consideration of the premium payment. If his fund is required to be maintained at a definite status at all times, the company may be required to pay over to the trustee additional cash to meet the premium payment.

If, however, the purchase of outstanding bonds at a premium is to continue, it would seem most desirable to charge off the premium annually against Profit and Loss account; or if a Sinking Fund Reserve account is maintained

(§§ 262, 283) the premium could be charged against it.

If the bonds are purchased in the open market at a discount, such discount may be credited either to Profit and Loss or to Surplus.

The entry at the date of purchase under the approved plan (3) is as follows:

January 1, 1919		
Sinking Fund Investments.....	\$50,000	
Premium on Sinking Fund Investments.....	1,250	
To Sinking Fund Trustee.....		\$51,250
For purchase of \$50,000 of the company's 5% bonds at 102½ by the trustee for sinking fund investment.		

If the sinking fund investments are not kept separately from the sinking fund cash, then an entry for the premium only would be necessary, and this premium must be disposed of by monthly entries, or at the end of the year by a debit to either Profit and Loss or Expense as follows:

December 31, 1919		
Profit and Loss.....	\$1,250	
To Premium on Sinking Fund Investments		\$1,250
To close this account for the year.		

The United States Steel Corporation charges off each year all premiums (upward of \$800,000 or more per year) on bonds purchased and held by the sinking fund trustee, this item together with the bond interest being entered as a deduction from net income. Some corporations create reserves to take care of these premiums, as "Reserves for Bond Redemption Premium" or some other appropriately named account.

§ 261. Entries for Bonds Cancelled Through Sinking Fund

The entries for bonds of the issuing company purchased and held by the trustee for sinking fund purposes, were set

forth in § 260. When the trust mortgage requires that the bonds of the company so purchased shall be turned over to the issuing company and cancelled, a different principle is involved and the status of the sinking fund is necessarily affected. The security to bondholders, however, remains the same in either case; indeed, from the bondholders' standpoint the cancellation of the bonds is preferable, since his margin of security automatically increases in proportion as the volume of outstanding bonds decreases. The trust agreement may stipulate, however, that as bonds are called for redemption and cancelled, certain modification of the security held may be made. For a further explanation of this subject, see Chapter XXII, "Redemption of Bonds."

Assuming that \$50,000 of bonds purchased by the Lenox Iron Works through the sinking fund trustee on January 1, 1919, were turned over to the company and cancelled, an entry would be required as follows:

January 1, 1919		
First Mortgage 5% Sinking Fund Bonds.....	\$50,000	
Premium on Bonds Cancelled.....	1,250	
To Sinking Fund Trustee.....		\$51,250
Purchase for cancellation of \$50,000 of the Company's 5% bonds at 102½ through the sinking fund trustee.		

If the trust mortgage provides that the sinking fund shall be maintained at a given amount, the company may be compelled to reimburse the trustee for the premium payment.

It may even be a condition of the cancellation agreement that the trustee shall be reimbursed in full for the amount expended in repurchasing the company's bonds. This must, of course, be provided for in advance. If at the time of cancellation the entire amount is paid over to the trustee, an entry similar to the following would be made:

January 1, 1919		
First Mortgage 5% Sinking Fund Bonds.....	\$50,000	
Premium on Bonds Cancelled.....	1,250	
To Cash.....		\$51,250
(Full explanation required.)		

This brings the sinking fund again up to its former status, but it is patent that unless the sinking fund is to be maintained regardless of the amount of the outstanding bonds, there is no necessity for continuing to reimburse the trustee for such bond purchases. The premium of \$1,250 may at the proper time be closed either into Profit and Loss or into the "Reserve for Bond Redemption Premium" in case the latter account is used.

§ 262. Entries for Sinking Fund Reserve

We have already stated (§ 250) that the deed of trust frequently requires an amount equal to the sinking fund instalments to be set aside out of profits.* To carry out this provision a definite amount agreeing with the sinking fund payment must be reserved each period, whether yearly or oftener, and credited to a reserve account set up for that purpose. Resorting again to the example under discussion, we will assume that the Lenox Iron Works is required to set aside each year out of profits an amount equal to that of the sinking fund instalments, \$50,000 per year. In that event it becomes necessary to withdraw the required amount out of profits by an entry similar to the following:

December 31, 1916		
Profit and Loss.....	\$50,000	
To Sinking Fund Reserve.....		\$50,000
To set aside profits equal to the sinking fund deposit for redemption of \$1,000,000 first mortgage 5% bonds, in accordance with the trust agreement.		

*See §§ 282, 283 for discussion of reserve accounts and reserve funds.

Whether or not this reserve shall be kept in harmony with the Sinking Fund account depends upon the trust agreement. In case this is a requirement, it is obvious that every dollar added to the fund must also have an equivalent credit to the reserve account, so that the two accounts will show like amounts though on opposite sides. This plan is illustrated in the following entries.

During 1917 the sinking fund accumulates a profit of \$2,000, which was credited to income and which must be reflected in the reserve account as well as in the sinking fund account. The following entry will therefore properly record the regular instalment of \$50,000 and the income for one year on the preceding deposit:

December 31, 1917

Profit and Loss.....	\$52,000	
To Sinking Fund Reserve.....		\$52,000
To set aside an amount equal to the annual deposit to the sinking fund, plus the profits accumulated for the year, as follows:		
Annual deposit to sinking fund...	\$50,000	
Income on previous balance reported by trustee.....	2,000	

An entry similar to the above must be made at the end of each year, comprising the regular instalment and all accrued profits for the year. This entry presupposes, of course, that additions to the sinking fund have already been charged to the trustee and credited to income on December 31, 1917 (§ 258), and again July 1 and December 31, 1918 (§ 259). As interest accumulations are reported by the trustee, adjusting entries are made to the Sinking Fund account; but under the plan adopted it may not be necessary to credit the sinking fund reserve until the end of the year, at which time the entry will include both the regular \$50,000 instalment and the accrued interest.

If it is desired, as is frequently the case, to credit earnings directly to the Sinking Fund Reserve account instead of to income, the following entry would be required for the \$2,000 above reported.

December 31, 1917		
Sinking Fund Trustee.....	\$2,000	
To Sinking Fund Reserve.....		\$2,000
For interest accretions to the sinking fund for year, as per report of the sinking fund trustee.		

If the Sinking Fund account and the Sinking Fund Reserve account are to be kept in harmony, certain adjustments may be required from time to time, as in the purchase of bonds of the issuing company or others at a premium. Referring to the investment of \$51,250 recorded in a previous section (§ 260), instead of charging this premium ... to a premium account it may be charged directly to the reserve account by an entry as follows:

January 1, 1919		
Sinking Fund Reserve.....	\$1,250	
To Sinking Fund Trustee.....		\$1,250
(Full explanation required here.)		

This entry if used would, of course, be incorporated in the entry referred to above. The amount might, if desired, be first charged to the premium account and in turn closed into the reserve account. There are many ways of making entries and it would be impracticable to enumerate them all. (See also § 283.)

§ 263. The Sinking Fund on the Balance Sheet

The sinking fund, consisting as it does of cash and securities, would naturally be placed among the assets in the balance sheet; but since the sinking fund assets are not free for use as working capital but have been handed

over to the trustee practically as part payment on the bonded debt, there is some question as to the expediency of including them among the balance sheet assets. Many companies list sinking fund assets among the corporate assets, while others show them as deductions from the bonded debt. The plan adopted depends largely on the ideas of the accounting officer or of the corporation officials. The following methods of listing are in common use, the amount of the sinking fund being as of December 31, 1918:

- | | | |
|--|-----------|---------|
| 1. Sinking Fund in Hands of Trustee..... | \$157,130 | |
| 2. Trustee of Sinking Fund, being amount of cash and securities held by the Trustee for redemption of \$1,000,000 5% First Mortgage Bonds of 1936..... | | 157,130 |
| 3. Sinking Fund Assets, being amount in hands of Trustee, as follows: | | |
| Invested in Securities..... | \$100,000 | |
| Cash in Savings Bank..... | 57,130 | 157,130 |
| <hr/> | | |
| 4. Sinking Fund Assets. (Cash and securities amounting to \$157,130 in hands of Trustee, deducted from outstanding bonds, per contra.) | | |

Under the last plan (4) the sinking fund assets appear only as a memorandum among the assets, while the amount of the funds is deducted from the bonds themselves on the opposite side.

§ 264. Entries on Books of Sinking Fund Trustee

The records of the trustee of a sinking fund are not kept in any standard form. Therefore, all that is necessary are full and complete accounts so that the conditions of the trust can be readily ascertained at any time. Of course, the accounts of a trustee and of the company should be in absolute harmony on all matters pertaining to the bond issue and the sinking fund.

The first official act of the trustee after the deed of trust is executed, is the indorsement of the bonds as they are

issued. A record of this is, of course, kept by the trustee, and this is the first entry on his books until either interest or a sinking fund instalment is received by him from the company, or interest becomes due on the bonds.

To illustrate the entries on the books of the sinking fund trustee, the transactions in connection with the bond issue of the Lenox Iron Works (§ 257) may again be taken. The first payment to the sinking fund trustee was \$50,000 in cash on July 1, 1916, this payment being made to meet the semiannual bond interest. The entry on the books of the Lenox Iron Works was as follows:

July 1, 1916		
Bond Interest.....	\$50,000	
To Cash.....		\$50,000
For payment of semiannual bond interest on \$1,000,000 5% bonds, due today at the office of the trustee, The Grove Street Trust Com- pany, to whom the check has been issued.		

The corresponding entry on the books of the sinking fund trustee is shown below:

July 1, 1916		
Cash	\$50,000	
To Coupons No. 1 (Lenox Iron Works) ..		\$50,000
First deposit of cash for payment of Coupon No. 1 on \$1,000,000 coupon bonds of the Lenox Iron Works.		

The coupons payable account will obviously remain open until all the coupons are paid. As payments are made, the trustee, of course, debits the coupon account and credits cash.

Upon receipt of the first sinking fund instalment the following entry was made on the books of the Lenox Iron Works:

December 31, 1916	
Sinking Fund Trustee (or Trustee of the Sinking Fund).....	\$50,000
To Cash.....	\$50,000
(Explanation.)	

The corresponding entry on the books of the sinking fund trustee is as follows:

December 31, 1916	
Cash	\$50,000
To Sinking Fund (Lenox Iron Works) ..	\$50,000
First sinking fund instalment of the Lenox Iron Works for redemption of \$1,000,000 first mortgage 5% bonds of 1916, due January 1, 1936.	

The succeeding entries of the sinking fund trustee would, as in those shown above, correspond to the entries on the company's books and therefore require no further illustration.

CHAPTER XXII

REDEMPTION OF BONDS

§ 265. Plans for Redeeming Bonds

The due date of any issue of bonds is stated in the deed of trust and also on the face of each bond. The deed of trust usually provides also that if any instalment of bond interest is not paid when due, and default continues for a specified length of time, the principal is thereby matured and must be paid. In event of continued default in either the principal or interest, it is usually provided that foreclosure may follow, or perhaps the trustee is authorized to take possession of the mortgaged property and operate it for the benefit of the bondholders.

The method of redeeming bonds depends largely on the nature of the particular bonds. The following methods are in general use:

1. Payment in cash at maturity, usually through the sinking fund.

2. By calling certain bonds each year for redemption. Under this method the numbers of the outstanding bonds are placed in a box or hat, shaken up, and a given number of them drawn, those drawn indicating the bonds which are to be redeemed. Legal notice of the numbers drawn for redemption is given to the bondholders by advertisement in the daily papers, and the bonds specified cease to bear interest from the date of the drawing, or some other specified date.

3. Refunding at maturity, in which case the bonds are cancelled and new ones issued in their place the

holders of the old bonds either taking new bonds, or cash secured by the sale of these new bonds, in exchange for their old bonds.

4. By serial payments. Under this plan serial bonds are issued, payable in instalments of so much per year during the currency of the bonds.

5. By conversion into stock of the company, either at a fixed date or at the maturity of the bonds, or at some other convenient time prior to maturity.

§ 266. (1) Redemption of Bonds Through Sinking Fund

Bonds redeemed through the sinking fund are paid at maturity by the trustee, who then passes the cancelled certificates over to the issuing corporation for final record. Sometimes the cancelled bonds are cremated (§ 278), though more frequently retained by the company as a permanent voucher.

The book entries at maturity of the bonds are very simple. To illustrate the entries necessary, the bond issue of the Lenox Iron Works may again be taken. This consisted of \$1,000,000 of first mortgage 5% sinking fund bonds due January 1, 1936. Assuming that the bonds have matured and that the sinking fund for their redemption amounts to \$992,000, leaving \$8,000 more to be made up by the company, book entries are required as follows:

January 1, 1936		
Sinking Fund Trustee.....	\$8,000	
To Cash.....		\$8,000
Cash paid over to the trustee of the sinking fund as per request, being the amount still required by him for payment of \$1,000,000 first mortgage bonds maturing this day.		

If the sinking fund had been scientifically calculated

and maintained at all times at a given rate of interest without loss, the required amount for the redemption of the bonds should be available at their maturity in the sinking fund. It is, however, for obvious reasons, but seldom that the sinking fund is exactly equal to the maturing bonds. When a shortage occurs the company must raise the additional funds. If, on the other hand, the fund is in excess of the required amount, such excess must, of course, be returned to the company after the bonds are redeemed.

Upon receiving notice from the trustee that all of the bonds have been redeemed, the following entry is made:

January 1, 1936		
First Mortgage Bonds.....	\$1,000,000	
To Sinking Fund Trustee.....		\$1,000,000
For payment by the trustee of \$1,000,000 first mortgage 5% twenty-year sinking fund bonds of 1916 due this day. The trust deed has been cancelled and the mortgage satisfied of record in the county recorder's office.		

Through the above entry, both the bond and the sinking fund accounts have been closed out. This results in the cancellation of two main accounts. The Sinking Fund Investments account, if kept on the company's books, should be closed into the trustee's account when he turns the securities into cash. In that case the entry given above should be preceded by the following entry, for the amount assumed to have been invested in securities:

Sinking Fund Trustee.....	\$900,000	
To Sinking Fund Investments.....		\$900,000
For conversion into cash by the trustee of sinking fund securities held by him to the amount of \$900,000.		

This entry is made regardless of whether the sinking fund investments are bonds of the issuing company or of other companies. The cancellation of all three accounts involved in the above entries might, of course, be accomplished through the one journal entry as follows:

First Mortgage Bonds.....	\$1,000,000	
To Sinking Fund Investments.....		\$900,000
" Sinking Fund Trustee.....		100,000
(Full explanation required here.)		

If a Sinking Fund Reserve account had also been created out of profits (see §§ 250 and 262), as is frequently the case, it can now be disposed of, as there is no further need of preventing the declaration of dividends to the impairment of current assets. The Surplus account or some permanent reserve can be credited with the amount of this account. Assuming that it has a credit balance of \$1,000,000, the following entry is required:

Sinking Fund Reserve.....	\$1,000,000	
To Surplus.....		\$1,000,000
(Full explanation required here.)		

This reserve may now be used for dividend purposes. If that is not desired, it should be credited to some account other than Surplus account, such as Capital Surplus, Appropriated Surplus, or Reserve for Depreciation.

§ 267. (2) Bonds Drawn by Lot for Redemption

When bonds are to be redeemed before maturity, the sinking fund trustee either advertises for the desired number of bonds at a stated price, draws certain numbers (bonds) by lot for redemption at a fixed price, or buys them in the market at the best prices obtainable. If the bonds to be redeemed are drawn by lot, in the case of

coupon bonds, notice thereof is given to the holders by means of newspaper advertisements; in the case of registered bonds, notices are sent direct to the holders. When bonds of the issuing company are purchased by the sinking fund trustee, they are, according to the provisions of the trust agreement, either retained as a sinking fund investment—unless resold later at a higher price—or are handed over to the issuing company and cancelled. The company's bonded indebtedness is in the latter case reduced to the extent of the bonds retired.

The investor frequently objects to the plan of drawing bonds for retirement, because he never knows when his number may be drawn. He must therefore be on the lookout at each interest period for the announcement of drawings, thereby causing a certain amount of anxiety. If he should overlook the announcement, he would hold his bonds and be deprived of the use of his money for the ensuing six months, discovering his loss at that time through the fact that his coupons came back unpaid. Also the plan results in a very short investment period for those whose bonds are called first, and an uncertain investment period for all the holders of the particular bonds. On the other hand, the fact that called bonds are usually purchased at a premium has a tendency to offset any trouble to which the investor may be put in watching for the newspaper notices of calls and through the uncertainty of his investment period.

The plan of selecting bonds for redemption by lot applies equally as well to debentures, short term notes, and other obligations. Bonds of clubs, institutions, office buildings, and the like, are frequently issued under this plan of redemption.

The following advertisement calling for bonds for redemption is typical:

REDEMPTION NOTICE

AMERICAN SMELTERS SECURITIES CO.

SIX PER CENT FIFTEEN-YEAR SINKING FUND GOLD BONDS, DATED
FEBRUARY 1, 1911

NOTICE IS HEREBY GIVEN that one million, three hundred and forty-seven thousand dollars (\$1,347,000) face amount of the above-described bonds were this day drawn for redemption as provided in Article Fourth of the Trust Agreement securing same, and numbered as follows:

(1368 numbers listed here)

All future interest on any of the bonds so designated ceases with the coupon due August 1, 1916.

In accordance with the foregoing, said numbered bonds will be paid at this office on and after the first day of August, 1916, at 105% and accrued interest.

CENTRAL TRUST COMPANY OF NEW YORK

Trustee

By GEO. W. DAVISON, *Vice-President*

Dated New York, April 17, 1916.

The following bonds, called for redemption on February 1, 1916, have not been presented for payment, viz.:

(139 numbers here)

§ 268. Entries for Bonds Called for Redemption

When bonds are called for redemption, they may, according to the terms of the deed of trust, be either retained by the sinking fund trustee as a sinking fund investment, or be turned over to the company for cancellation. Entries for bonds redeemed for sinking fund investment will be found in § 260; entries for bonds purchased by the sinking fund trustee for cancellation will be found in § 261.

§ 269. (3) Refunding Bonds

As already stated, a bond issue may be renewed or "funded" by a new issue of bonds bearing equally as good or better security. The deed of trust may even contain

a provision giving the company the option of calling the bonds on or after a certain date. The reason for this is apparent. If the bonds are issued at a time when the interest rate is high or when the company is not well-known, the inclusion of a redemption clause that may be taken advantage of when the company is better known or stronger financially, or the money market is easier, would seem wise and prudent, as it may then call the old bonds and reissue new bonds bearing a lower rate of interest. Other conditions may arise also which would render the refunding of bonds before maturity necessary or advisable.

Nearly all railroad bonds are issued with the expectation of refunding at maturity. There are several reasons for this practice, but chiefly because of the relation of the bondholder to the corporation. Bond investors desire a fair return on their money, a sufficient guarantee that the principal is well secured, and assurance that such an investment is permanent and not likely to be interrupted. A long time investment with a certainty of security and interest payments at a reasonable rate is greatly preferred to short time paper even at a higher rate of interest. For this reason, the refunding of bonds when the company is of unquestioned financial strength is looked upon with favor.

On the other hand, corporation interests are also well served by the refunding of bonds as opposed to their redemption in cash. If the company can make 10% on its investment in business activities, it seems better to use the money in that way than to set it aside in a sinking fund to earn 3 or 4%.

Turning from the railroads, it is apparent that long time or refunding bonds are not likely to be issued on properties having a short life or a wasting nature; as the ordinary manufacturing plant, a coal mine, standing tim-

ber, or tracts of land which are to be broken up into building lots. In cases of this kind the sinking fund method or the serial bond almost invariably prevails.

Public utility corporations, as a rule, keep increasing their bonded debts until the limit prescribed by charter is reached, so that when one issue is cancelled another and larger issue replaces it, and as the process goes on any underlying or prior lien obligations are likely to be combined in the new issue.

§ 270. Entries for Refunding Bonds

For illustration of the entries required where bonds are refunded, we will assume that the first mortgage 5% bonds of the Pleasant Valley Electric Railway Company for \$10,000,000 matured July 1, 1916, and that they were refunded by part of a new issue of consolidated first mortgage 5% fifty-year bonds for \$20,000,000. The following entry is required for the refunding operation:

July 1, 1916

First Mortgage 5% Bonds (maturing)...	\$10,000,000	
To Unissued Consolidated First		
Mortgage 5% Bonds (or Cash)		\$10,000,000
Refunding of \$10,000,000 first mortgage 5% bonds due this day at the office of the trustee, the Barton Trust Company. The bonds have been cancelled and returned and the mortgage satisfied of record.		

In cases such as this the new bonds may either be exchanged for the old, as assumed above, or they may be sold in the usual way and cash used for redeeming the maturing obligations. This latter plan is the more general and is the one employed by the Pennsylvania Railroad Company and many other large companies.

§ 271. (4) Redemption of Serial Bonds

Serial bonds have already been discussed in § 192. The bonds are usually paid in annual instalments of given amounts beginning a few years after the date of issue; therefore the redeeming process is a continuous feature after it is once started. Like other mortgage bonds, serial bonds are usually payable at the office of the company's fiscal agent or at the office of the trustee, but in any case the money required for their redemption is paid over by the company as the instalments mature. The interest coupons are payable by the company or its fiscal agent.

Assuming that the first mortgage 6% serial bond issue of \$3,000,000 of the Georgian Paper and Pulp Company is payable in instalments of \$150,000 each year beginning February 1, 1919, and that the date for paying the first instalment is at hand, the following retirement entry is made:

February 1, 1919

First Mortgage 6% Serial Bonds.....	\$150,000	
To Cash.....		\$150,000
Payment of Instalment No. 1 of the \$3,- 000,000 first mortgage serial 6% bonds of 1916.		

As the bonds are paid they are cancelled and handed over to the company for record. In place of the above entry two entries may be substituted if desired, one crediting cash and debiting the trustee as the cash is paid over, and the other debiting the bond account and crediting the trustee as the bonds are received by the company.

Under the trust deed the company has the privilege of paying off additional instalments in order of serial numbers (or the reverse order), in advance of maturity, at 103 and interest. As already explained in § 260, the pre-

mium paid for such redemption is in turn closed into Profit and Loss. In that case the entry differs from the above only with respect to premium paid, and is:

First Mortgage 6% Serial Bonds.....	\$150,000	
Premium on Redeemed Bonds.....	4,500	
To Cash.....		\$154,500
(Full explanation required here.)		

§ 272. (5) Entries for Convertible Bonds

A convertible bond, as already stated (§ 191), is one which under prescribed conditions carries the right of conversion into other securities of the same corporation. These convertible bonds may be exchanged for stock of the company at a stated price, provided the holders thereof care to take advantage of the privilege. For instance, the convertible 4 1/2% bonds for \$67,000,000 of the American Telephone and Telegraph Company are convertible at par into stock of the company at \$120 per share from March 1, 1915, to March 1, 1925. When the convertible bonds are issued provision is, of course, made so that there may be a sufficient amount of unissued stock or other securities to which the conversion privilege will apply.

The entries required to give expression to such a conversion are quite simple:

Convertible Bonds, etc.....	.....
To Unissued Stock (or other security)...	.....
" Premium on Stock.....	.....
(Full explanation.)	

§ 273. Redemption of Collateral Trust Bonds

The entries for the redemption of collateral trust bonds are not different from those for the redemption of ordinary mortgage bonds, except that the security which had

passed out of the company's possession at the date of issue now comes back. An extra entry is required to record this transfer.

Assuming that the due date of the Harney Electric Company's \$1,000,000 twenty-year collateral trust 5% gold bonds, interest payable half-yearly, has arrived, that they have been paid by the trustee, and that the collateral has been released to the company, the entry required at the time is:

July 1, 1936

Collateral Trust 5% Bonds.....	\$1,000,000	
To Cash.....		\$1,000,000
Payment of \$1,000,000 twenty-year 5% collateral trust bonds matured this day at the office of the trustee, the Hudson Trust Company.		

If desired, this amount may first be charged to the trustee, if payment is made by him, and be followed by another entry debiting the bond account and crediting the trustee.

The collateral security now having been released to the company may be recorded by the following entry:

July 1, 1936

Investments	\$1,340,000	
To Pledged Investments.....		\$1,340,000
Return of collateral pledged with the Hudson Trust Company as security for \$1,000,000 collateral trust bonds, as follows: (Here list details and values of stocks and bonds returned.)		

This returns the securities to the Investments account, and they are now free for use in other ways if necessary. The explanations given above apply also to secured short term notes, and like obligations.

§ 274. Redemption of Short Term Notes

Short term notes (§ 203) are either secured or unsecured, and as they mature they are paid like other bond obligations, and the book entries required are similar to those for other classes of bonds. If the notes are secured by a deposit of collateral, an entry should be made as soon as the collateral is returned, removing the collateral from the Pledged Collateral account and returning it to the Investments account, as in the case of collateral trust bonds. Unissued, or nominally issued, bonds of the company that have been pledged as security for bank loans or other obligations, should in like manner be recorded in some distinguishing account.

§ 275. Redemption of Equipment Trust Bonds

Equipment certificates are usually issued in series, as Series A, B, C, etc., each being secured by a given portion of the equipment. As each instalment of the certificates is paid by the trustee out of money supplied by the company, the equipment trust certificates are cancelled and returned to the company. As soon as a series is paid off, which may require two or three instalments, the equipment thereunder is released to the company. It is then transferred from the trust equipment account to the free equipment account. Assuming that upon payment of the first instalment of \$1,000,000 of an equipment trust bond issue, one-fifth of the equipment held as security is released to the company, it would be reflected in the following entries, it being assumed that the released equipment is of the value of \$2,000,000:

July 1, 1916

Equipment Trust Certificates.....	\$1,000,000	
To Cash.		\$1,000,000
First instalment of 6% equipment trust certificates paid this day, etc.		

This entry is then followed by a transfer entry somewhat as follows:

Equipment Cars (or Locomotives).....	\$2,000,000	
To Equipment Trust Cars.....		\$2,000,000
For transfer of \$2,000,000 of equipment released under equipment trust cer- tificates. (Full explanation.)		

§ 276. Redemption of Guaranteed Bonds

Guaranteed bonds are issued, as a rule, by subsidiary or affiliated companies (see § 197), and should be redeemed by the issuing company. A contingent liability is, however, incurred by the guaranteeing company as soon as the bonds are indorsed, but it is not usual to make any entry in the books of account at the time. A complete record of the matter is, of course, made in the corporate minutes. If no entry is made when the bonds are indorsed by the company, then no entry is necessary at their maturity so long as they are duly paid by the issuing company. On the other hand, if an entry is made at the beginning, an offsetting entry is required when the bonds are paid by the issuing company.

If the guaranteeing company is required to make payment for all or any part of the bond issue, it must then, of course, make an entry debiting the issuing company and crediting cash, and will look to the issuing company for reimbursement. The Pennsylvania Railroad in 1915 had outstanding guaranteed stock trust certificates of underlying companies aggregating \$14,393,250, of which \$7,478,250 matures in 1948 and \$6,915,000 in 1921.

§ 277. Bonds in Default

In case of default in the payment of bonds, or even in the interest thereof, the trustee is usually empowered

by the deed of trust to enter upon and take charge of the mortgaged property for the benefit of the bondholders. In that event the company is forced into bankruptcy, or a receivership, or a reorganization of some kind, unless the bondholders consent to an extension or renewal, or to some other plan of adjustment that will permit the company to continue its career. For instance, the Missouri Pacific Company's 5% secured notes for \$25,000,000, due June 1, 1914, were extended for one year with interest at 6%. Again, in 1915 these notes were renewed for another year, over 95% of the holders having agreed to the extension. Those not agreeing to the extension were paid in cash.

Unpaid bond obligations should, by right, be removed from the regular bond account and credited to some other account that will clearly designate the nature of the obligation, as:

Four-Year Secured 6% Notes.....	\$600,000	
To Matured Four-Year 6% Notes....		\$600,000

An account may even be opened for "Defaulted 6% Notes," "Overdue 6% Notes," "Renewed 6% Notes," or "Extended 6% Notes," as the case may require.

§ 278. Destroying Bonds

When bonds are redeemed by the trustee they are, of course, cancelled, and they are then either returned to the company or cremated by the trustee. The advisability of burning retired bonds is a matter of dispute. If done at all, it is done in the presence of the officers of the issuing company and of the trust company, all of whom sign in duplicate a cremation certificate, their signatures being duly witnessed. The cremation certificate reads about as follows:

"This is to certify that we, the undersigned, have this day in the presence of each other, destroyed the following described securities by burning the same to ashes." (Here follows a detailed description of the securities burned.)

Part V—Corporation Reports and Statements

CHAPTER XXIII

CLOSING THE BOOKS; RESERVE FUNDS AND SURPLUS

§ 279. Closing the Books

At the end of each fiscal year, or oftener, it is customary to "close the books," that is, "close the ledger." Where it can be done conveniently, it is usual and advisable to make the fiscal year correspond with the calendar year; but in many cases it is preferable to have the fiscal year end at a time when business is slack, or when the inventory can be taken with the least labor. In the dry-goods business, for instance, the fiscal year might be made to close just before the fall merchandise comes in, when the stock is low, so that the physical inventory may be taken with comparative ease. Under the modern plan of keeping perpetual or book inventories, however, a physical inventory is not necessarily taken before closing the books, and the end of the fiscal year is usually made to coincide with the end of the calendar year.

At the closing date it is the practice to prepare such statements, usually profit and loss statement and balance sheet, as will clearly exhibit the business operations of the company for the year and also show its true financial condition at the time.

Financial statements do not, however, in themselves necessitate a closing of the books, and they are frequently made up monthly, quarterly, or half-yearly for the purpose of supplying information which the officers and directors

need before the time of the annual closing. This does not mean that the ledger is closed, or changes made in any of the accounts, but simply that the required balances, inventory totals, and accrued items are compiled from the books and records as they stand, and are presented in condensed form to the corporation officials. A complete profit and loss statement can be made each month with but little extra work, provided a running inventory is maintained in the records. In many companies, however, it is the practice to make adjusting entries each month to bring the ledger into harmony with the monthly profit and loss statement and balance sheet. In that case all prepaid and accrued items, as interest, insurance, taxes, etc., must be considered. The distribution of overhead expenses is also a feature of great importance in the case of manufacturing establishments.

§ 280. Procedure in Closing the Books

The steps to be taken in closing the books are briefly as follows:

1. Determine the inventories of merchandise, properties, supplies, etc., making adjustments where necessary, and enter them in the proper respective accounts.
2. Compute and group prepaid and accrued items and make entries to the proper accounts.
3. Determine depreciation of properties and make entries for same.
4. Consider and enter reserves of whatever nature.
5. Close the nominal accounts into Profit and Loss account, usually by journal entry. Journal entries may be used also for the entering of inventories and accruals. The net profit or net loss is then carried to Surplus account or to Undivided Profits account.
6. Balance and rule the nominal accounts and bring down the inventories where necessary.

7. Make a second trial balance of the ledger. This would now consist only of assets and liabilities and the balance of the Profit and Loss account.

8. Prepare income and profit and loss statement showing gross and net profit, accompanied by analyses and percentages when desired. Show comparisons of items with like items from preceding years where desirable.

9. Prepare balance sheet showing the company's net worth and financial condition. Show comparisons with assets and liabilities of preceding years where desirable.

10. Prepare other exhibits, schedules, or summaries as required.

11. Contingent assets or liabilities should be noted, at least as a footnote to the balance sheet, and adjustments made where necessary.

§ 281. Closing the Ledger

The ledger must be closed systematically with the various nominal or profit and loss accounts properly subdivided. For example, all accounts directly affecting production costs should be closed into the Manufacturing account, in order to determine the exact cost of the finished stock; and all selling expenses, administrative expenses, etc., should be carefully classified and closed in accordance with the degree of information required and the plan of the bookkeeping system. The net profit must, of course, be clearly stated, and sometimes the gross profit as well. It is not necessary to close the real or asset and liability accounts, except when they are balanced by settlement or adjustments, or when forwarding them to another page or to another ledger.

Monthly trial balances should, of course, be made of all ledgers, and the main ledger be in balance before it is closed.

When closing the ledger, transfers of the nominal ac-

counts to the manufacturing accounts and to the Profit and Loss account are usually, though not necessarily, made by journal entry. Transfers might be made directly on the face of the ledger without supporting journal entries or explanation, but it is preferable to make such transfers through the journal; this summarizes all of the items and provides a means of supporting each ledger entry by adequate explanation. The journal explanations may be very brief, but should be clear and unmistakable for the benefit of others who may have to make reference thereto.

It is in closing the ledger preparatory to the making of the statements that many of the more difficult problems of accounting arise. With this in view, the following sections have been devoted to a brief discussion of most of these points.

The methods of handling the accounts peculiar to corporations when preparing statements have already been treated in considerable detail (see especially Chapter VI, "Distinctive Corporate Accounts"), so that discussion of them has been omitted in this chapter.

RESERVE FUNDS

§ 282. Reserve Accounts

Reserves represent profits set aside for definite and specific purposes. The prudent business man is careful not to overstate his profits, and, to prevent this, due allowance is made in the form of reserves to meet any anticipated or expected losses. They include all amounts reserved or kept back for future use, as reserve for bad debts, reserve for depreciation, reserve for discounts, reserve for insurance or sick benefits, reserve for sinking fund, etc. For instance, it is a well-known fact that customers' accounts are frequently uncollectible, and experience has shown the advisability of making due allowance for such losses. The following

reserve for bad debts, against which worthless accounts may be charged directly as they occur or at the end of the year through the Bad Debts account, illustrates the working of a reserve account.

RESERVE FOR BAD DEBTS

1916		1916	
Dec. 31	Bad Debts written off during the year and charged to Bad Debts account	Jan. 1	Balance \$3,680.29
" "	Balance 3,502.94	Dec. 31	Profit and Loss 3,291.40
	<u>\$6,971.69</u>		<u>\$6,971.69</u>
		1917	
		Jan. 1	Balance \$3,502.94

§ 283. Reserve Accounts and Reserve Funds

When profits are reserved for a particular purpose, and specific funds or property are set aside or invested to meet the needs of this reserve, a reserve fund is thereby created. Thus, if a reserve is created for the redemption of bonds or for the replacement of a wasting asset, by the reservation of cash, or by the investment of cash in securities, the cash or securities being held for the specific purpose of redeeming the bonds, the result is a *sinking fund* or replacement fund, as the case may be. If, however, a reserve is created for the redemption of bonds by a charge against Surplus or Profit and Loss, but no actual reservation of cash or other property is made, the result is a *sinking fund reserve*. In the one case the actual cash is withdrawn and held, and it, or its equivalent if it is invested, is there for the redemption of the bonds as they fall due. In the other case, the profits have

been withdrawn from Surplus or Profit and Loss, as the case may be, so that they cannot be declared in dividends or diverted to other uses.

This being so, when the bonds fall due, their redemption will not impair the capital or reduce the surplus, because of the reserve; but this is all the reserve does, and the directors must then take such steps as may be necessary to secure cash to pay the bonds. Sufficient cash may perhaps be in the treasury for the purpose, but, in the case of a large amount of bonds or an entire issue falling due, this is seldom the case; as a result cash must be borrowed or be secured by the sale of some of the company's property to meet redemptive needs. For this reason, to provide for the redemption of bonds or the liquidation of any heavy obligation, the reserve fund, or both fund and reserve are generally set up.

Reserve accounts are in the nature of liabilities and are always shown on the balance sheet as credits, or as a deduction from assets, while funds of whatever nature are assets and therefore appear on the debit side or otherwise as a deduction from liabilities. Loss of assets for which reserves have been provided is written off by a debit to the reserve and a credit to the specific asset. An examination of the balance sheets appearing in Chapters XXV, XXVI will show the different reserve accounts and the manner of handling them.

§ 284. Secret and Hidden Reserves

The terms "hidden reserves" and "hidden assets" are practically synonymous with "secret reserves." The latter term is familiar to accountants as representing the excess of actual net worth of a concern over and above the amount indicated on its balance sheet. For some reason, the directors may not wish to disclose in a financial statement the true status of the company's condition, and they act accord-

ingly in understating the true facts. This may be due to a spirit of conservatism which is no doubt permissible in case no one is injured thereby. Sometimes, however, the actual net profits for a given year are understated for the purpose of lessening the state and federal corporation tax, and perhaps to keep both stockholders and competitors in ignorance of the company's actual earnings.

Following are various acts or omissions which result in the creation of secret reserves :

1. Intentionally or inadvertently omitting assets which should be included.
2. Undervaluing assets, intentionally or otherwise.
3. Writing off too much depreciation.
4. Charging additions and improvements to Repairs or Maintenance account instead of to Plant account.
5. Creating reserves for bad debts in excess of the amount required.
6. Charging production costs intentionally or otherwise, to general expense instead of to the manufactured article, thus undervaluing the cost.
7. Including fictitious liabilities in the accounts, or overstating actual liabilities.
8. Making additions or improvements and charging the cost to Surplus account, thereby hiding their value.
9. Neglecting to take into consideration in the accounts natural increases in value of real or other property.
10. Understating values in good years and increasing them in lean years as a means of keeping the dividends uniform from year to year.

The hidden reserve is a commendable creation in case it

is not carried to excess and provided it is not detrimental to interested persons. The spirit of conservatism, to a reasonable extent, is to be commended by the accountant rather than criticized. If, however, stockholders are kept in ignorance of secret reserves of considerable amount, the auditor should draw attention to this fact in his report.

§ 285. Depreciation

Depreciation is the reduction in the value of a fixed asset through use, the passage of time, or obsolescence. All property, with the possible exception of land, must inevitably reach the end of its usefulness, since disintegration is the law of nature. Machinery in use suffers from wear and tear. Machinery not in use is subject to depreciation from rust and decay. Whether in use or not, the onward march of invention and improvement in mechanical lines, together with the necessity of meeting sharp competition in business, requires that machinery shall be modern in every respect. Accordingly, obsolete machinery must be replaced by modern equipment.

In the case of machinery or equipment designed for manufacturing purposes, depreciation is considered a part of the cost of production.

§ 286. Methods of Handling Depreciation

There are several methods of handling depreciation on the books. Since it is not possible to determine the exact rate at which properties will depreciate, it becomes necessary to follow the results of past experience. From this it is possible to determine with reasonable certainty the life of a given property; and the rates of depreciation may then be approximated.

The methods more commonly employed in caring for depreciation are as follows:

1. Even portions of the original value are charged off each year.
2. An annual per cent of the diminishing value is charged off each year.
3. Depreciation is offset by improvement and maintenance charges.

The life of machinery is from five to twenty years, depending upon the usage to which it is subjected. It is manifest that the rate on diminishing values must be higher than the rate on the original value. If a machine is likely to run for twenty years, then a fair rate of depreciation would be 5% on the original cost and from 7 to 10% on the diminishing balance. The method of diminishing values seems the more logical of the first two methods of caring for depreciation, since the burden is distributed more equitably and the property has a residual value at all times. It throws the heaviest charge for depreciation on the first few years when the machinery is in good condition, and then gradually decreases as the efficiency of the property is impaired. On the other hand, the repairs during the last years are larger than at the beginning, so that the annual deduction from profits is not unequally distributed.

All repairs should, of course, be charged to Repairs account and then closed into Profit and Loss account, or perhaps treated as a manufacturing cost. Additions and permanent improvements should be charged to the property account benefited thereby, and be subjected to the same process of depreciation as the original property. There are very few cases, if any, where repairs and improvements can take the place of an ample provision for depreciation.

The rates of depreciation on different kinds of properties have been carefully compiled by engineers and accountants, and depreciation tables have been worked out from these calculations, which will be found convenient.

The first method of depreciation requires no illustration. The following account will show the application of the second method.

MACHINERY ACCOUNT

(10% Depreciation off Diminishing Values Annually)

1915		1915	
Jan. 1	Investment . . . \$100,000.00	Dec. 31	Depreciation.. \$10,000.00
			Balance 90,000.00
	<u>\$100,000.00</u>		<u>\$100,000.00</u>
1916		1916	
Jan. 1	Balance \$ 90,000.00	Dec. 31	Depreciation.. \$ 9,000.00
			Balance 81,000.00
	<u>\$90,000.00</u>		<u>\$90,000.00</u>
1917			
Jan. 1	Balance \$ 81,000.00		

This process is continued from year to year until the value of the machinery is consumed, or it is sold or discarded. If the depreciation proves too high or too low, modification of the percentage rate used or other adjustments may be necessary.

If statements are required each calendar month, necessitating a distribution of depreciation, it will be necessary to make an entry each month debiting Depreciation and crediting the property account for one-twelfth of the annual amount to be written off. In lieu of this process, a good plan is to make entries only at the end of the year for the amount to be written off, while the monthly distribution is made on separate analysis sheets. In this way the information required for monthly statements can be compiled on loose sheets without affecting the ledger accounts or necessitating so many journal entries.

§ 287. Reserve for Depreciation

Instead of writing down the property account from year to year, a more generally approved plan of entering depreciation on the books is to set up a "Reserve for Depreciation." It is credited each year or each month with the amount to be written off, while a corresponding charge is made to Profit and Loss, to Operating Expense, or to Depreciation account. It is apparent that under this method the property account remains on the books at its cost value, while the corresponding reserve account stands as an open credit on the books and in the trial balance. This is more satisfactory than a direct credit to the property account, since it shows at any time the book accounts of properties at their cost price, and the depreciation reserves set up against them.

Where properties are written down very rapidly by actual credits to the property account, it is hard to convince the insurance adjuster, in case of loss by fire, that they are really worth more than the balances shown in the accounts. Of course, it is not assumed that either the corporation officials or the insurance adjuster would be influenced by the account alone without an investigation of the facts; yet it is nevertheless a difficult matter to show that properties are really worth more than the owner has actually valued them in his book accounts. While the property and reserve accounts are shown separately in the books, in the balance sheet the reserve for depreciation is frequently deducted from the property, thus:

Plant and Machinery.....	\$100,000.00	
Less Reserve for Depreciation.	10,000.00	\$90,000.00

§ 288. Operation of Reserve for Depreciation Account

A general reserve account may be opened for deprecia-

tion of all properties, or a separate reserve account may be opened for each class of property. This depends, of course, upon the different kinds of properties to be depreciated and on the plans of the supervising accountant. It should be remembered that reserves are not surplus profits, but merely negatives to, or deductions from, the corresponding assets. Instead of deducting these depreciation reserves from their corresponding assets, as shown in the illustration above, they are frequently placed in the balance sheet among the liabilities. Any addition to the Machinery account will, of course, require a corresponding increase to the annual reserve. In case a machine becomes obsolete and is discarded, it must be charged off to the reserve account as follows:

Reserve for Depreciation.....	\$14,500	
To Machinery Account.....		\$14,500
To write off obsolete and worn-out machinery as follows: (Here give details.)		

The sale of old machinery or of scrap necessitates a debit to Cash and a credit to Reserve for Depreciation or to Profit and Loss account. If an ample depreciation account is maintained for all properties, any machine becoming obsolete or worthless before the time estimated should, in like manner, be written off against Reserve for Depreciation. In case the reserve is not sufficient to offset the entire amount, then the excess must be charged to Profit and Loss. The accountant or careful corporation official will see that the depreciation reserve is maintained at an amount amply sufficient for every purpose.

§ 289. Sinking Fund for Exhaustion of Mines

In the ordinary commercial undertaking the profits are made on the turnover, and at the end of a term of years the investment—save in case of disaster—is intact, and pre-

sumably the business is far more valuable than when it was started. In mining and similar undertakings, however, the profit is made from the removal of the mineral, and under ordinary conditions the value of the property becomes steadily less with each ton of ore removed, until on its final exhaustion there is left a tract of rough and worthless land and machinery of but little further value. In other words, the original investment has disappeared—has been consumed, or realized upon, in the course of operation.

This gradual working out or liquidation of the original investment is characteristic of mining, quarrying, timbering, and other operations, and, if the conditions are clearly recognized, is not in any way objectionable. Frequently, however, the owners prefer to establish a sinking fund or depreciation reserve that will preserve the integrity of the original investment, so that profits only will be paid the owners from current operation.

The establishment of such a sinking fund, or "exhaustion" or "replacement" fund as it is frequently called, is a comparatively simple matter. The amount of mineral in the mine, or of timber on the tract, is estimated; and a certain amount calculated to replace the original investment upon or before the exhaustion of the property, is reserved and set aside for each ton of ore mined, or for each thousand feet of lumber cut. For instance, the Cambria Steel Company carries a "Reserve for Extinguishment of Minerals" aggregating some \$500,000; the Bethlehem Steel Corporation carries a "Reserve for Depreciation of Property, Exhaustion of Minerals, etc.," of over \$10,000,000; the International Harvester Company carries a "Reserve for Plant Depreciation and Extinguishment" of over \$10,000,000; and the United States Steel Corporation has reserves for similar purposes aggregating over \$24,000,000.

The amount reserved for exhaustion or replacement is

deducted from profits and credited to a special reserve account; but, since the creation of such a reserve is entirely at the option of the owners, the actual assets may remain in the business, or, if preferred, may be set aside in cash as a special exhaustion fund. If cash is drawn from the business to provide this special fund, it may either be placed in the hands of a trustee, or of a committee of directors, or of the entire board. Unlike a bond sinking fund where the deed of trust requires cash to be withdrawn, the exhaustion fund is generally a voluntary matter and may be regulated as seems best to the owners of the property.

§ 290. Insurance, Benefit, and Accident Funds

The creation of special funds and reserves for insuring properties against loss by fire, for sickness and pensions, for old age benefits, and against accidents and other contingencies, is a common feature of modern corporation finance.

The United States Steel Corporation in its last annual report shows reserves on the liability side of its balance sheet as follows:

- Contingent and Miscellaneous Operating Funds
- Pension Fund
- Insurance Funds

The Pennsylvania Railroad Company maintains the following funds, the purposes of which are apparent:

- Consolidated Mortgage Sinking Fund
- Insurance Fund for Fire, Marine, etc.
- Employees' Voluntary Relief Fund
- Employees' Saving Fund
- Employees' Pension Fund

The International Harvester Company in its annual report shows the following reserves on the liability side of its balance sheet:

Depreciation and Extinguishment
Special Maintenance
Collection Expenses on Receivables
Fire Insurance Fund
Pension Fund
Industrial Accident Fund
Profit-Sharing
Contingent (European War Losses, etc.)

The three representative corporations cited above may be taken as fair examples of the modern practice in the matter of creating reserves and funds. Except in a few of the compulsory cases, the reserves are not represented by specially appropriated assets, thus indicating that the regular cash assets are relied upon to meet any demands made from these sources.

SURPLUS

§ 291. Surplus or Undivided Profits Account

"Surplus" account usually contains all those profits that are not reserved for some special purpose or which are not immediately to be distributed in the form of dividends. Or, more broadly, it is the account in which is entered all excess of assets over liabilities which is available for dividends or other general purposes of the company. In the balance sheet it is represented by the excess of assets over liabilities and capital, the difference being a credit either to Surplus, or to Undivided Profits, or sometimes to Profit and Loss. Where a surplus exists, it is usually maintained as a measure of safety to strengthen the financial condition of the company and to safeguard it against unforeseen contingencies. In England and extensively in Canada, the surplus is called the "Reserve Fund."

Surplus account may be credited with the year's net

profit before the dividend is declared, or with the portion of profits to be retained in the business after payment of dividends. Dividends are usually not declared until the amount of net profit is known, unless the unapportioned surplus is ample to cover any shortage that might result; to do otherwise might result in wiping out the reserve that had been created during prosperous years. A large surplus is the pride of every well-managed corporation, and especially of banking institutions in which the surplus is frequently larger than the capital stock itself.

Banks usually make a distinction between surplus and undivided profits. Each year they carry a given amount of the net profit to Surplus account to serve as permanent working capital, while the remainder after payment of dividends is carried in the Undivided Profits account. Many corporations make no distinction but use either one or the other for all purposes. Some use "Surplus and Undivided Profits" account, or "Surplus and Deficiency" account, while others use only the Profit and Loss account.

The Surplus account is frequently entitled "Surplus and Deficiency" account, in order that it may, without misnomer, not only accommodate surplus but any deficiency as well. This is the plan used by public service commissions in their schedules and reports. The account is credited with surplus profits and charged with such net loss as may result in any year. A debit excess of this account, of course, represents a deficiency or impairment of capital, while a credit excess is the opposite.

§ 292. Contributed Surplus

Sometimes stock is subscribed for at a figure above its par value, and a surplus is thus created by contribution at the time the company is organized. This is done in order that the company may have a safety fund for emergencies,

or additional working capital while the business is being launched. In that case Surplus account is usually credited for the amount contributed in excess of the capital stock. This plan is commonly employed in the organization of national banks in which the stockholders are liable for debts of the company to an amount equal to the stock they hold. The practice is to sell the stock at, say, \$125, \$150, or even \$200 per share, in which case the double liability of the stockholders is completely provided for and the institution itself secures a material addition to its working capital.

Surplus is sometimes the result of a direct acquisition of value not belonging to the fiscal period or to the opening of business, as an increase in value of real estate, of investments, or of other assets of a permanent nature. If such increase is permanent, it may legitimately be credited to Surplus account. Property value increases, however, if used for the purpose of creating a fictitious surplus on which to declare dividends, should be severely condemned by accountants and corporation officials. It is not good business prudence in any case to use appreciation of values for dividend purposes. Dividends declared and paid on the strength of fictitious profits must, as a rule, be accounted for in case of the company's failure; it is equivalent to paying dividends out of capital for which the directors are held personally liable.

§ 293. Investments of Surplus

It is common practice for corporations to invest part of their surplus cash in gilt-edged securities, such as bonds and stocks of other companies. This insures the company against danger of being without liquid funds in case of a crisis; but, on the other hand, when the low rate of return from these securities is considered, it is manifest that the money thus invested could be used more profitably in the

business. However, most corporations follow the practice of investing in such securities, knowing that they can be used at any time as collateral for securing bank loans or for sale on the stock exchange.

It should be remembered that any "surplus" is always represented by an equivalent of assets, but as a rule these assets are not earmarked or in any way designated except perhaps as investments. In case a special surplus fund is created by setting aside cash, an account must be opened under the caption "Surplus Fund" or "Investments," or any other designating term. Such outside investments may, but generally do not, represent all of surplus profits. Surplus account always shows a credit balance (unless a deficit occurs), while the surplus fund (or any other fund) shows a debit balance. Income from surplus funds invested should, of course, be credited to Income account.

CHAPTER XXIV

FORMS OF STATEMENTS

§ 294. Corporate Reports

There are two types of corporate reports and statements: those rendered by the directors and corporate officials to the stockholders and governmental authorities, and those rendered by the accounting department of the corporation to the executives. It is to the latter class that the present discussion will be directed.

§ 295. Necessity for Reports

To manage the business intelligently it is essential that corporate officials be constantly informed as to the financial status and progress of the concern. In the case of the small corporation where the executives are in intimate touch with the daily activities of the business, monthly or even quarterly statements of income and profit and loss, and balance sheets are adequate to give them sufficient information to run the business properly.

In the case of the large corporation, however, where the scope of activity and the volume of business is such that it is absolutely impossible for the executive to keep in close personal touch with the various details of the business, it is the duty of the accounting department to provide suitable statements and statistical data to keep him thoroughly informed. In an organization of this type it may be necessary to have daily reports showing in memorandum form the essential facts of the business such as the sales, pur-

chases, collections, expenditures, bank balances, manufacturing or operating details; weekly or monthly statements of cash receipts and disbursements; monthly statements of income and profit and loss, and balance sheets, together with such other statistical information as may be needed.*

§ 296. Form of Statements

While there are no generally accepted or standard forms for corporate statements, those given on the following pages are fairly representative of the best practice. Modifications may often prove desirable to meet the needs of local conditions, but, when making these modifications, the accountant must be most careful to see that the statements as rendered will not be misleading to anyone, and that they convey information to those who will use them in as interesting and clear a manner as possible. The forms given in Chapters XXV, XXVI, in connection with the problems illustrating the preparation of corporate statements, are suggestive of modifications that are good.

§ 297. Balance Sheets

BALANCE SHEET, DECEMBER 31, 19..

Assets

Current Assets:

Cash	\$.....	
Notes and Accounts Receivable.....		
Inventories		\$.....

Deferred Charges to Operation:

Prepaid Insurance, etc.....		
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Plant Assets:

Real Estate.....	\$.....	
Machinery, Fixtures, etc.....		

*For further details, see "Accounting Practice and Procedure" by Dickinson, and "Auditing—Theory and Practice" by Montgomery.

Other Assets:

Good-Will Patents, etc.....	\$.....	
.....		
		\$.....

Liabilities

Current Liabilities.:

Notes Payable.....	\$.....	
Accounts Payable.....		
Accrued Wages.....	\$.....	

Fixed Liabilities:

Bonded Debt.....		
Reserves		

*Excess of Assets
(Or Net Worth)*

Capital Stock.....	\$.....	
Surplus (or Deficit).....		\$.....

COMPARATIVE GENERAL BALANCE SHEET

AT DECEMBER 31, 19.., AND AT DECEMBER 31, 19..

	December 31, 19..	December 31, 19..	Increases Decreases*
<i>Assets and Deferred Debit Items:</i>			
CAPITAL ASSETS:			
Land	\$.....	\$.....	\$.....
Factory and Office Buildings.....			
Building Equipment.....			
Power Plant.....			
Machinery and Tools.....			
Experimental and Improvement Plant			
Maintenance Plant.....			
Printing Plant.....			
Transportation Plant.....			
Furniture and Fixtures.....			
Trade-Marks and Patents.....			
Total Capital Assets.....	\$.....	\$.....	\$.....

*Decreases are shown in red.

COMPARATIVE GENERAL BALANCE SHEET—*Continued*

	December 31, 19..	December 31, 19..	Increases Decreases*
WORKING AND TRADING ASSETS:			
Working:			
Goods in Process—Inventory.....	\$.....	\$.....	\$.....
Manufacturing Materials and Sup- plies—Inventory			
Materials for Repairs and Main- tenance—Inventory			
Scrap Material—Inventory.....			
Shipping Material—Inventory.....			
Coal, Oil, and Waste—Inventory...			
Advertising Matter.....			
Stationery and Printing.....			
	\$.....	\$.....	\$.....
Trading:			
Finished Goods—Inventory.....			
Total Working and Trading.....	\$.....	\$.....	\$.....
Total Capital and Working and Trading Assets.....			
	\$.....	\$.....	\$.....
CURRENT ASSETS:			
Cash in Banks and in Office.....	\$.....	\$.....	\$.....
Special Deposits.....			
Notes Receivable.....			
Customers' Accounts Receivable....			
Claims against Transportation Cos..			
Advances to Employees.....			
Total Current Assets.....	\$.....	\$.....	\$.....
DEFERRED DEBIT ITEMS:			
Fire Insurance Premiums, unex- pired portion.....	\$.....	\$.....	\$.....
Freight and Cartage Outward, ap- plicable to goods finished, ware- housed, and unsold.....			
Total Deferred Debit Items.....	\$.....	\$.....	\$.....

*Decreases are shown in red.

COMPARATIVE GENERAL BALANCE SHEET—*Continued*

	December 31, 19..	December 31, 19..	Increases Decreases*
Total Current Assets and Deferred			
Debit Items.....	\$.....	\$.....	\$.....
Total Assets and Deferred Debit			
Items	\$.....	\$.....	\$.....
<i>Liabilities and Surplus:</i>			
CAPITAL LIABILITIES:			
Capital Stock Authorized, Issued and Outstanding.....	\$.....	\$.....	\$.....
Real Estate Bond and Mortgage...			
Total Capital Liabilities.....	<u>\$.....</u>	<u>\$.....</u>	<u>\$.....</u>
CURRENT LIABILITIES:			
Notes and Loans Payable.....	\$.....	\$.....	\$.....
Accounts Payable:			
(a) To Creditors.....			
(b) " Employees—Wages Ac- rued			
(c) " Salesmen—Salaries, Com- missions and Expenses.			
(d) " Employees—Profit Shar- ing Scheme.....			
(e) " Employees—Deposits for Use of Tools.....			
(f) " State—For Taxes.....			
Total Current Liabilities.....	<u>\$.....</u>	<u>\$.....</u>	<u>\$.....</u>
Total Liabilities.....	<u>\$.....</u>	<u>\$.....</u>	<u>\$.....</u>
SURPLUS:			
(a) Appropriated:			
For Reserves for Claims against Transportation Companies	\$.....	\$.....	\$.....
For Reserves for Deprecia- tion of Physical Assets....			

*Decreases are shown in red.

COMPARATIVE GENERAL BALANCE SHEET—Continued

	December 31, 19..	December 31, 91..	Increases Decreases*
For Possible Losses of Ac- counts Receivable.....			
Total Appropriated.....	\$.....	\$.....	\$.....
(b) Available for Dividends.....			
Total Surplus.....	\$.....	\$.....	\$.....
Total Liabilities and Surplus.....	\$.....	\$.....	\$.....

§ 298. Statements of Income and Profit and Loss**STATEMENT OF INCOME AND PROFIT & LOSS**

FOR THE YEAR ENDED DECEMBER 31, 19..

Sales	\$.....
Less Returns.....	.....
Net Sales.....	\$.....
Deductions from Sales:	
Allowances	\$.....
Outward Freight and Cartage.....	.....
Income from Sales.....	\$.....
Manufacturing Cost of Goods Sold:	
Purchases of Raw Materials.....	\$.....
Inward Freight and Cartage.....	.....
	\$.....
Add—Decrease in Inventory of Raw Material..	.....
	\$.....
Direct Labor.....	.....
Superintendence .....	.....
Factory Office Salaries.....	.....
Heat, Light, and Power.....	.....
Factory Supplies.....	.....

*Decreases shown in red.

STATEMENT OF INCOME AND PROFIT & LOSS—*Continued*

Factory Expense.....	.....	
Factory Repairs.....	.....	
Depreciation of Operating Equipment.....	.....	
	\$.....	
Deduct—Increase in Inventory of Goods in Process .....	.....	
Total Manufacturing Cost.....	.....	
Add—Decrease in Inventory of Finished Goods .....	.....	
Total Manufacturing Cost of Goods Sold.....	.....	
Gross Profit on Sales.....	\$.....	
Selling Expense:		
Salaries of Sales Manager and Clerks.....	\$.....	
Salaries of Salesmen.....	.....	
Salesmen's Commissions.....	.....	
Traveling Expense.....	.....	
Advertising .....	.....	
Selling Profit.....	\$.....	
Administrative Expense:		
Salaries of Officers.....	\$.....	
Salaries of Clerks.....	.....	
Stationery and Printing.....	.....	
Postage .....	.....	
Telephone and Telegraph.....	.....	
General Expense.....	.....	
Net Profit on Sales—Income from Operations.....	\$.....	
Other Income:		
Income from Securities.....	\$.....	
Interest on Notes Receivable.....	.....	
Cash Discount on Purchases.....	.....	
Total Income.....	\$.....	
Deductions from Income:		
Interest on Bond and Mortgage Payable.....	\$.....	
Interest on Notes Payable.....	.....	
Cash Discount on Sales.....	.....	
Insurance .....	.....	

STATEMENT OF INCOME AND PROFIT & LOSS—*Continued*

Taxes		
Net Income—Profit and Loss.....		\$.....
Profit and Loss Credits:		
Profit on Purchase of Consolidated Trading		
Company 6% Bonds.....	\$.....	
Profit on Purchase of National Products Com-		
pany 6% Bonds.....		.....
Profit and Loss—Gross Surplus for the Period.....		\$.....
Profit and Loss Charges:		
Provision for Depreciation of Buildings.....	\$.....	
Provision for Contingencies.....		.....
Profit and Loss for the Period.....		\$.....
Profit and Loss Surplus at Beginning of Period.....		.....
Profit and Loss Surplus Before Deducting Dividends.....		\$.....
Dividends Declared.....		.....
Profit and Loss Surplus, December 31, 19.....		\$.....

STATEMENT OF INCOME AND PROFIT AND LOSS

FOR THE YEAR ENDED DECEMBER 31, 19..

Income from Sales:

Gross Sales.....	\$.....
Less Returns.....	.....
Net Sales.....	\$.....

Deductions from Sales:

Allowances to Customers:	
On Sale Price.....	\$.....
On Damaged Goods.....	.....
Freight and Cartage Outward—on Sales.....	.....
Stable and Automobile Expense—Proportion	
Applicable to Sales.....	
Total Deductions from Sales.....	\$.....

Income from Sales.....	\$.....
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STATEMENT OF INCOME AND PROFIT & LOSS—*Continued**Cost of Goods Sold:*

Manufacturing Cost of Goods Finished During the Period:

Prime Cost:

Materials and Supplies Consumed—Including

Freight and Cartage thereon..... \$.....

Productive Labor

Total Prime Cost..... \$.....

Manufacturing Overhead:

Superintendence \$.....

Unproductive Labor
Heat, Light, and Power
Factory Expense
Repairs and Maintenance, Machinery and
Tools

Total Manufacturing Overhead..... \$.....

General Factory Overhead:

Salaries and Wages—Shipping Department.. \$.....

Shipping Material Consumed
Shipping Department Supplies
Miscellaneous Shipping Expense
Traveling Expense—Shipping Department...
Stationery and Printing Consumed by Factory

Total General Factory Overhead..... \$.....

Total Manufacturing Cost for the Period..... \$.....

Deduct—Increase of Inventory of Goods in

Process as between January 1 and Decem-

ber 31, 19.....

\$.....

Add—Decrease of Inventory of Goods in

Process as between January 1 and Decem-

ber 31, 19.....

Manufacturing Cost of Goods Finished During
the Period \$.....

Inventory Adjustment:

Deduct—Increase of Inventory of Finished

STATEMENT OF INCOME AND PROFIT & LOSS—*Continued*

Goods as between January 1 and December 31, 19.., after deduction therefrom of the value of goods distributed free, and used by salesmen.....	.....	
		\$.....
Add—Decrease of Inventory of Finished Goods as between January 1 and December 31, 19.., after deduction therefrom of the value of goods distributed free, and used by salesmen .....	.....	
Manufacturing Cost of Goods Sold.....	\$.....	
Additional Cost—Freight, Handling and Warehousing of Raw Materials Consumed.....	.....	
Total Cost of Goods Sold.....	.....	
Gross Profit and Sales.....	\$.....	
<i>Selling Expense:</i>		
Salaries of Selling Management.....	\$.....	
Salaries, Commissions, and Expenses of Salesmen .....	.....	
Advertising Expense.....	.....	
Free Goods.....	.....	
Traveling Expense of Sales Manager.....	.....	
Premiums .....	.....	
Stationery and Printing Consumed by Office of Sales Manager.....	.....	
Special Inducements to Jobbers.....	.....	
Salesmen's Samples used in demonstration....	.....	
Sundry Expense of Sales Office.....	.....	
Total Selling Expense.....	.....	
Selling Profit.....	\$.....	
<i>Administrative and General Expenses:</i>		
<i>Administrative:</i>		
Office Salaries.....	\$.....	
General Office Expenses and Supplies.....	.....	
Telephone and Telegrams.....	.....	
Legal Expense.....	.....	

STATEMENT OF INCOME AND PROFIT & LOSS—*Continued*

Traveling Expense of Administrative Officers..	.....	
Postage Expense.....	.....	
Stationery and Printing—Office.....	.....	
Heat and Light—Office.....	.....	
Miscellaneous .....	.....	
	\$.....	
General:		
Repairs and Maintenance of Buildings.....	\$.....	
Experimental Expense—Processes and New Goods .....	.....	
Experimental Expense—Machinery.....	.....	
	\$.....	
Total Administrative and General Expense.....	.....	
<i>Profit from Operations</i>	\$.....	
<i>Additions to Income:</i>		
Interest on Notes Receivable.....	\$.....	
Sundry Sales of Materials and Empty Con- tainers .....	.....	
Discounts Gained on Creditors' Accounts (Cash Discounts).....	.....	
Interest on Bank Balances.....	.....	
Total Additions to Income.....	.....	
Total	\$.....	
<i>Deductions from Income:</i>		
Taxes, Licenses, and Fees.....	\$.....	
Fire Protection.....	.....	
Discounts Lost on Customers' Accounts (Cash Discounts) .....	.....	
Interest and Discounts—Notes Payable.....	.....	
Collection Fees and Other Bank Charges.....	.....	
Total Deductions from Income.....	.....	
<i>Gross Profit and Income from Operating and Other Sources</i>	\$.....	
<i>Extraordinary Losses of the Period:</i>		
Frozen Goods.....	\$.....	

STATEMENT OF INCOME AND PROFIT & LOSS—*Continued*

Accounts Receivable—Uncollectible.....	.....
Breakage of Carboys and Other Empty Containers Returnable to Shippers.....	.....
Total Extraordinary Losses of the Period.....	.....
<i>Net Profit for the Year Ended December 31, 19.....</i>	<i>\$.....</i>
<i>Reserved:</i>	
For Depreciation of Physical Assets.....	\$.....
For Possible Losses of Accounts Receivable... ..	.....
Total Reserved.....	.....
<i>Profit and Loss Surplus at December 31, 19.....</i>	<i>\$.....</i>
<i>Surplus at January 1, 19.....</i>	<i>\$.....</i>
Less Adjustments during the Period:	
Returned Sales of prior periods, and Frozen Goods sold in prior periods, the profit on which figures in the surplus as established at January 1, 19., including freight and all expenses paid by the Company on such returns .....	.....
Net Adjusted Surplus, January 1, 19.....	.....
<i>Surplus at January 1, 19.. (as per Balance Sheet of this Company given in the foregoing).....</i>	<i>\$.....</i>

§ 299. Statement of Cash Receipts and Disbursements

STATEMENT OF CASH RECEIPTS AND DISBURSEMENTS

FOR THE YEAR ENDED DECEMBER 31, 19..

Debits—Cash Received:

(1) From the Collection of Current Assets:	
Customers' Accounts.....	\$.....
Claims against Transportation Companies. ....	.....
Notes and Loans Receivable, and Interest thereon .....	.....
	<u>\$.....</u>
(2) From the Sale of Working Assets:	
Materials and Supplies Sold to Employees \$.....	.....

CASH RECEIPTS AND DISBURSEMENTS—*Continued*

Carboys and Empty Containers.....	.....	.....
(3) From the Incurrence of Liabilities:		
Notes and Loans Payable.....	\$.....	
Deposits by Employees.....	.....	
Credit Accounts of Officers.....	.....	.....
(4) From Miscellaneous Sources:		
Fire Insurance Premiums Refunded.....	\$.....	
Dividends on Mutual Fire Policies.....	.....	
Refunds by Creditors, for overpayments and allowances not deductible from bills	.....	.....
(5) Total Receipts for Period.....		\$.....
(6) Balance on Hand, January 1, 19.....		.....
(7) Total Debits.....		\$.....
<i>Credits—Cash Disbursed:</i>		
(1) For Liabilities Liquidated:		
To Creditors.....	\$.....	
" Employees—for Wages.....	.....	
" Banks for Loans and Notes.....	.....	
" Mortgagee—for Reduction of Mort- gage .....	.....	\$.....
(2) To Interest on Indebtedness.....		.....
(3) For Reduction of Credit Accounts of Officers.....		.....
(4) For Pre-Process Cost of Goods Manufactured:		
Freight and Cartage Inward and Handling Charge.		.....
(5) For Factory Overhead Expenses:		
Automobile Expense.....	\$.....	
Warehouse Charges and Cartage.....	.....	
General Expense of Factory.....	.....	
Miscellaneous Shipping Expense.....	.....	.....
(6) For Selling Expenses:		
Salaries and Commissions of Salesmen..	\$.....	
Advertising Expense.....	.....	
Special Commissions to Jobbers.....	.....	.....
(7) For General and Administration Expense:		
Salaries	\$.....	

CASH RECEIPTS AND DISBURSEMENTS—*Continued*

Postage Expense.....	.....	
Telephone and Telegrams.....	.....	
Traveling Expense of Officers.....	.....	
Legal Expense.....	.....	
Miscellaneous Expense.....	.....	.....
(8) Total Cash Disbursements for Period.....		\$.....
(9) Balance on Hand, December 31, 19.....		.....
(10) Total Credits.....		\$.....

CHAPTER XXV

PREPARATION OF STATEMENTS—MANUFACTURING CORPORATION

The object of this and the following chapter is to illustrate with actual figures how the different periodic statements are made up, first for a manufacturing business and then for a trading business, and to show the different methods of arranging the items. A comparison of the operating statements and balance sheets will indicate different methods of classification and arrangement, thus indicating that there is no ideal form that could be used in all cases. Accountants differ in their ideas of making statements, though in every case the net results would be the same. It will be noted that the statements of the Lake Manufacturing Company are arranged in account form, the debits and credits being on opposite sides; while in the case of the Bryant-Chase Company a different order obtains, the debits being given first, followed immediately by the credits.

§ 300. Trial Balance

The following trial balance shows the balances of the various accounts of the Lake Manufacturing Company for the fiscal year ending December 31, 1916:

LAKE MANUFACTURING COMPANY TRIAL BALANCE, DECEMBER 31, 1916

Cash	\$40,324.00
Cash Deposit for Dividend No. 11.....	4,100.00
Cash Deposit for Bond Interest.....	5,000.00

Land	200,000.00	
Buildings	300,000.00	
Machinery	200,000.00	
Tools and Implements.....	40,430.00	
Horses, Wagons, and Harness.....	30,000.00	
Office Furniture.....	5,201.00	
Notes Receivable.....	25,812.00	
Accounts Receivable.....	163,374.00	
Sinking Fund.....	30,000.00	
Investment of Surplus.....	20,000.00	
Salesmen's Accounts—Advances on Salaries	1,960.00	
Organization Expenses Unapportioned....	14,700.00	
Bond Discount Unamortized.....	12,000.00	
Dividend No. 11, 5%, authorized July 1, 1916	45,000.00	
Good-Will	150,000.00	
Unsubscribed Stock.....	100,000.00	
Notes Payable.....		\$42,000.00
Accounts Payable.....		103,561.00
First Mortgage 5% Twenty-Year Bonds....		200,000.00
Special Accounts—Officers and Clerks.....		15,363.00
Bond Interest Coupons Due.....		5,000.00
Dividend No. 11, Vouchers Outstanding....		4,100.00
Reserve for Bad Debts—less \$1,940 written off		112.00
Reserve for Depreciation—Buildings, 2½%.		5,000.00
Reserve for Depreciation—Machinery, 6%..		18,000.00
Reserve for Depreciation—Horses, Wagons, etc., 10%.....		3,000.00
Capital Stock, 10,000 shares at \$100.....		1,000,000.00
Sinking Fund Reserve.....		30,000.00
Sales, less Returns and Allowances.....		1,250,550.00
Rent of Part of Business Premises.....		500.00
Inventory, December 31, 1915 (Material \$74,621; Finished Stock \$30,000).....	104,621.00	
Purchases	390,000.00	
Freight and Cartage Inbound.....	5,662.00	
Labor—Factory Pay-Rolls.....	600,400.00	
Salaries of Officers and Clerical Force.....	75,120.00	
Salaries of Salesmen.....	60,440.00	
Advertising	50,300.00	
Taxes Paid.....	4,020.00	
Insurance	2,600.00	
Bond Interest.....	10,000.00	

Interest and Discount	6,500.00	
Expenses—Stable	4,000.00	
Expenses—Office, Legal, and Unclassified...	25,750.00	
Maintenance—Repairs, Buildings, etc.....	26,942.00	
Profit and Loss, 1915 Surplus.....		77,070.00
	<u>\$2,754,256.00</u>	<u>\$2,754,256.00</u>

Inventories, December 31, 1916:

Finished Stock	\$160,560.00
Materials and Work in Process.....	110,000.00
Factory Pay-Rolls, Accrued but Not Paid.....	5,750.00
Unexpired Insurance	912.00
Interest Accrued on Investments.....	1,000.00
Interest Earned on Sinking Fund.....	1,200.00

From the foregoing trial balance and notations, it is possible to prepare a manufacturing account, a trading and profit and loss account, and a balance sheet, as of December 31, 1916. The same reserves for depreciation are to be made as at the end of the preceding year. 10% is to be written off from the balance of organization expenses, and 5% off of bond discount. 2% of notes and accounts receivable is to be allowed as a provision against possible losses. A further appropriation of \$30,000 is to be made to the sinking fund, the cash to be given to the trustee on January 2, 1917. As a final balance, the profits available for distribution are to be shown as a credit balance to Undivided Profits account.

Below the balance sheet proper, under the head "Contingent Liabilities," should be noted any obligations on which the company is contingently liable, such as discounted notes, and similar possible obligations. Contingent liabilities include those on which the company is liable in a secondary way, the liability on which becomes absolute only in case of the failure of some one else involved to carry out his obligation.

§ 301. Manufacturing Account

LAKE MANUFACTURING COMPANY

MANUFACTURING ACCOUNT FOR YEAR ENDED DECEMBER 31, 1916

<i>Costs</i>		<i>Output</i>	
Inventory of Material, January 1, 1916....	\$74,621.00	Output for year, cost of manufactured	
Purchases	390,000.00	stock carried to Trading and Profit and	
Freight and Cartage, Inbound.....	5,662.00	Loss Account.....	\$1,018,583.00
Labor in Factory.....	606,150.00		
	<u>\$1,076,433.00</u>		
Less Inventory of Material and Work in			
Process, Dec. 31, 1916.....	110,000.00		
Prime Cost.....	<u>\$966,433.00</u>		
Manufacturing Charges:			
Maintenance of Buildings and			
Machinery	\$26,942.00		
Taxes	4,020.00		
Insurance	1,688.00		
Depreciation of:			
Buildings, 2½%.....	7,500.00		
Machinery 6%.....	12,000.00		
	<u>52,150.00</u>		
Total Production Costs.....	<u>\$1,018,583.00</u>		
			<u>\$1,018,583.00</u>

§ 302. Trading and Profit and Loss Account

LAKE MANUFACTURING COMPANY
TRADING AND PROFIT AND LOSS ACCOUNT
FOR YEAR ENDED DECEMBER 31, 1916

		<i>Credits</i>	
<i>Debits</i>			
Inventory of Finished Stock, January 1, 1916	\$30,000.00	Sales, less Returns and Allowances.....	\$1,250,550.00
Cost of Finished Stock, from Manufacturing Account.....	1,018,583.00	Other Income:	
		Rent of Part of Premises....	\$500.00
		Interest Accrued on Investments	1,000.00
			1,500.00
Less Inventory of Finished Stock, December 31, 1916.....	\$1,048,583.00	Total Income.....	\$1,252,050.00
	160,560.00		
	\$888,023.00		
Selling Expenses:			
Salaries of Salesmen.....	\$60,440.00		
Depreciation of Horses,			
Wagons, etc.....	3,000.00		
Stable Expenses.....	4,000.00		
Advertising	50,300.00		
	117,740.00		

General Expenses:

Salaries—Office	\$75,120.00
Bond Interest.....	10,000.00
Interest and Discount.....	6,500.00
Expenses—Office, Legal and Unclassified	25,750.00
Reserve for Bad Debts, 2%..	3,784.00
Organization Expenses Writ- ten Off.....	1,470.00
Bond Discount Written Off.	600.00
	<u>123,224.00</u>
Total Charges.....	\$1,128,987.00
Net Profit carried to Undivided Profits account.....	<u>123,063.00</u>
	<u>\$1,252,050.00</u>

UNDIVIDED PROFITS

(Showing apportionment of net profit for 1916)

Dividend No. 11, July 1, 1916.....	\$45,000.00
Sinking Fund Reserve.....	30,000.00
Balance, Unapportioned.....	48,063.00
	<u>\$123,063.00</u>
Net Profit for year, from Profit and Loss Account	<u>\$123,063.00</u>

§ 303. Balance Sheet

LAKE MANUFAC
BALANCE SHEET AT CLOSE OF

<i>Assets</i>		
Current Assets:		
Cash on Hand.....		\$40,324.00
Notes Receivable	\$25,812.00	
Accounts Receivable	163,374.00	189,186.00
Finished Stock		160,560.00
Materials and Work in Process		110,000.00
Total Current Assets		\$500,070.00
Special Funds:		
Sinking Fund with Trustee, including		
Earnings*	\$31,200.00	
Surplus Fund Investments	20,000.00	
Cash, Balance of Dividend No. 11.....	4,100.00	
Cash, Deposit for Bond Interest.....	5,000.00	60,300.00
Fixed Assets:		
Land	\$200,000.00	
Buildings	300,000.00	
Machinery	200,000.00	
Tools and Implements	40,430.00	
Horses, Wagons, etc.	30,000.00	
Office Furniture	5,201.00	
Total Fixed Assets		775,631.00
Miscellaneous Assets:		
Good-Will	\$150,000.00	
Advances to Salesmen.....	1,960.00	
Insurance Unexpired	912.00	
Interest Accrued	1,000.00	
Bond Discount Unamortized.....	11,400.00	
Organization Expenses Unapportioned.....	13,230.00	178,502.00
		\$1,514,503.00

*Another deposit of \$30,000 due January 2, 1917.

TURING COMPANY

BUSINESS, DECEMBER 31, 1916*

Liabilities and Capital

Current Liabilities:

Notes Payable	\$42,000.00	
Accounts Payable	103,561.00	\$145,561.00

Special Accounts:

Officers and Clerks		15,363.00
Bond Interest Coupons Due		5,000.00
Dividend No. 11, Vouchers Outstanding.....		4,100.00
Wages Accrued, Factory Pay-Roll.....		5,750.00

Total Current Liabilities.....		\$175,774.00
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Fixed Liabilities:

First Mortgage 5% Twenty-Year Bonds.....		200,000.00
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Reserve Accounts:

For Sinking Fund	\$60,000.00	
Interest Earned on above.....	1,200.00	
For Bad Debts	3,896.00	
For Depreciation of:		
Buildings	12,500.00	
Machinery	30,000.00	
Horses, Wagons, etc.	6,000.00	113,596.00

Total Liabilities		\$489,370.00
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Capital and Profits:

Capital Stock	\$1,000,000.00	
Less Stock Unsubscribed.....	100,000.00	

Stock Outstanding	\$900,000.00	
Surplus from last year.....	77,070.00	
Undivided Profits for 1916.....	48,063.00	

Net Worth of Company.....		1,025,133.00
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		<u>\$1,514,503.00</u>
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§ 304. Closing Entries in Journal

The following journal entries are required to adjust and close the various ledger accounts of the Lake Manufacturing Company which have been affected by the business operations of the year. Two divisions of the nominal accounts are made—the Manufacturing account, and the Trading and Profit and Loss account in which the various accounts are summarized.

December 31, 1916

Manufacturing Account.....	\$1,076,433	
To Inventory of Material, January		
1, 1916.....		\$74,621
" Purchases		390,000
" Freight and Cartage.....		5,662
" Labor—Factory Pay-Rolls.....		600,400
" Labor—Accrued		5,750
To establish the Manufacturing account		
by transferring the above accounts		
thereto.		

Materials and Work in Process, December		
31, 1916.....	\$110,000	
To Manufacturing Account.....		\$110,000
To enter inventory of material and work		
in process on the accounts stated, in		
order to determine prime cost of goods		
used.		

Manufacturing Account.....	\$52,150	
To Maintenance Charges.....		\$26,942
" Taxes		4,020
" Insurance		1,688
" Reserve for Depreciation of		
Buildings		7,500
" Reserve for Depreciation of		
Machinery		12,000

To close the above manufacturing costs into Manufacturing account. (The unexpired insurance is entered directly to the account and not posted through the journal.)

Trading and Profit and Loss Account.....	\$1,048,583	
To Inventory of Finished Stock,		
January 1, 1916.....		\$30,000
" Manufacturing Account.....		1,018,583

To establish the Trading and Profit and Loss account by transferring thereto the inventory of finished goods on hand at the beginning of the year, and the manufactured output for 1916.

Sales, Net.....	\$1,250,550	
Inventory of Finished Stock, December 31,		
1916	160,560	
To Trading and Profit and Loss		
Account		\$1,411,110

To close Sales account into Trading account and to establish inventory of finished goods as at the end of the year.

Trading and Profit and Loss account.....	\$117,740	
To Salaries of Salesmen.....		\$60,440
" Reserve for Depreciation of		
Horses, Wagons, etc.....		3,000
" Stable Expenses.....		4,000
" Advertising		50,300

To close the various selling expenses into Profit and Loss account.

Trading and Profit and Loss account.....	\$123,224	
To Salaries—Office		\$75,120
" Bond Interest.....		10,000

To Interest and Discount.....		6,500
" Expenses—Office, Legal and Un- classified		25,750
" Reserve for Bad Debts.....		3,784
" Organization Expenses.....		1,470
" Bond Discount.....		600
To close the above general administra- tion charges into Profit and Loss, and to write off 2% for bad debts, 10% for organization expenses, and 5% for bond discount.		
Sublease of Premises.....	\$500	
Interest Accrued on Investments.....	1,000	
To Profit and Loss.....		\$1,500
To close miscellaneous income accounts into Profit and Loss.		
Trading and Profit and Loss.....	\$123,063	
To Undivided Profits.....		\$123,063
To close Profit and Loss account and transfer the net profit of \$123,063 to the Undivided Profits account.		
Undivided Profits.....	\$75,000	
To Dividend No. 11, July 1, 1916...		\$45,000
" Sinking Fund Reserve.....		30,000
To close interim dividend account and to appropriate \$30,000 to the sinking fund reserve.		

This completes the closing entries. It is apparent that, instead of grouping the items as shown, further subdivisions could have been made. More detailed explanations of the journal entries might be advantageous, but it will be seen that certain explanations are made in the statements themselves as an aid to a clearer understanding of them. Bad debts written off during the year, amounting to \$1,940,

were charged directly to the Reserve for Bad Debts account established at the close of 1915.

§ 305. Comments on Closing of Lake Manufacturing Company's Books

The balance sheet exhibits the various assets and liabilities of the company, conveniently grouped and classified. The various reserves are placed among the liabilities as negatives to the corresponding assets. They are frequently placed on the debit side as deductions from the assets. The sinking fund reserve is an exception, since it remains on the credit side as profits which eventually revert to surplus. The balance sheet should be prepared so as to exhibit the affairs of the company in a clear, unmistakable way, the form being varied to meet the needs of the particular business.

The year's operating results are set forth in the Manufacturing account and the Trading and Profit and Loss account. The first statement exhibits the manufacturing output for the year after allowing for work in process. The balance is carried to the profit and loss statement as the cost of finished stock. The Profit and Loss account includes the income from other sources, also the various selling and administrative expenses and the resultant net profit.

The Undivided Profits account contains the profits of the year remaining unapportioned and available for dividends.

It is apparent that the Lake Manufacturing Company does not have a complete cost system. If it had, the book inventory of material, work in process, and finished stock would be available. As the matter stands, physical inventories have to be taken in order to determine these values.

Bond interest coupons are payable January 1, 1917, and \$5,000 has already been deposited with the fiscal agent for their payment. A like amount has been charged against

Profit and Loss and credited to Bond Coupons Due. Counteracting entries are required as the coupons are paid and turned over to the company.

When the semiannual dividend of \$45,000 was declared, a charge was made to Dividend account and a credit to Dividends Payable. When the voucher checks were issued, Dividends Payable account was debited and Dividend Vouchers credited; cash entries not having been made until the vouchers were returned from the bank. As a result, the dividend vouchers still unpaid are clearly shown, which in this case amount to \$4,100.

Allowance has been made for depreciation of properties and for possible losses on bad debts. The sinking fund trustee already has \$31,200 in his possession, this including \$1,200 of accumulated interest. Another appropriation of \$30,000 must be turned over to the trustee on January 2, 1917, the Sinking Fund Reserve account already having been credited with this amount.

Surplus profits for the year, amounting to \$48,063, still remain on hand, after deducting the sinking fund reserve and the interim dividend of July 1. Another semiannual dividend will no doubt be declared, resulting in a further decrease of \$45,000. Surplus funds, amounting to \$20,000, have been set aside and invested in securities to be available when necessity arises.

Ample deductions have been made from organization expenses and from bond discount, both being amortized over a term of years.

Among the assets the special funds amount to \$60,300. These are appropriated for special purposes and set apart to distinguish them from other available funds of the business.

CHAPTER XXVI

PREPARATION OF STATEMENTS—TRADING CORPORATION

§ 306. Trial Balance

The following trial balance of the Bryant-Chase Company, dealers in general merchandise, is as of December 31, 1916:

BRYANT-CHASE COMPANY

TRIAL BALANCE, DECEMBER 31, 1916

Cash	\$17,800.00	
Notes Receivable.....	28,520.00	
Accounts Receivable.....	93,410.00	
Stock Subscriptions.....	50,000.00	
Investments	30,000.00	
Treasury Stock.....	30,000.00	
Real Estate, Buildings, and Machinery.....	210,000.00	
Furniture and Fixtures.....	34,600.00	
Delivery Equipment.....	14,500.00	
Consigned Goods to Agent, Not Sold.....	2,800.00	
Charges on Consigned Goods Not Sold.....	80.00	
Notes Payable.....		\$38,800.00
Accounts Payable.....		66,550.00
Reserve for Depreciation.....		3,140.00
Reserve for Bad Debts.....		2,100.00
Capital Stock Outstanding.....		250,000.00
Capital Stock Subscribed.....		50,000.00
Working Capital Donated.....		30,000.00
Sales		390,000.00
Goods Consigned to Agents, at Cost.....		14,600.00
Subrent of Warehouse.....		450.00
Profit on Sale of City Property.....		1,250.00
Profit on Consignment Sales.....		2,340.00
Interest on Investments.....		200.00
Discount on Purchases.....		1,990.00
Rebates and Allowances on Purchases.....		1,130.00

TRIAL BALANCE—*Continued*

Freight Inbound.....	3,150.00	
Rebates and Allowances on Sales.....	1,580.00	
Inventory, December 31, 1915.....	86,000.00	
Purchases	210,000.00	
Wages to Clerks and Packers.....	16,600.00	
Salaries to Officers and Office Help.....	8,400.00	
Salaries and Expenses of Salesmen.....	8,890.00	
Office Expenses.....	4,600.00	
General Expenses.....	3,400.00	
Stable and Delivery Expenses.....	2,300.00	
Rent of Warehouse.....	2,500.00	
Commissions Paid.....	2,800.00	
Discount on Sales.....	3,460.00	
Freight Outbound.....	1,840.00	
Cartage	350.00	
Warehouse Expenses.....	630.00	
Light and Heat.....	540.00	
Repairs	1,120.00	
Interest on Bank Charges.....	290.00	
Interest on Cancelled Mortgage.....	100.00	
Insurance and Taxes.....	320.00	
Donations	230.00	
Bad Debts Written Off.....	2,050.00	
Loss on Sale of Securities.....	320.00	
Undivided Profits on December 31, 1915.....		20,630.00
	\$873,180.00	\$873,180.00

At this time, allow \$3,000 additional as a reserve for bad debts, and \$10,660 additional as a reserve for depreciation. Salaries are overpaid by \$200. Accrued interest on investments, \$850. The directors have, December 31, 1916, declared a dividend of 20% (dividend No. 2) on the outstanding capital stock, payable January 25, 1917.

In closing the books the following statements are required:

1. Trading and profit and loss statement for the year.
2. Balance sheet drawn up in suitable grouping.
3. Percentage statement based on the net sales.

§ 307. Trading and Profit and Loss Statement

BRYANT-CHASE COMPANY

TRADING AND PROFIT & LOSS STATEMENT

FOR YEAR ENDED DECEMBER 31, 1916

Earnings

Gross Sales.....	\$390,000.00	
Less Allowances and Rebates.....	1,580.00	\$388,420.00
Inventory, January 1, 1916.....	\$86,000.00	
Purchases	\$210,000.00	
Freight Inward.....	3,150.00	
	\$213,150.00	
Less Allowances and Rebates.....	1,130.00	
	\$212,020.00	
Less Goods Consigned to Agents, at cost	14,600.00	197,420.00
		\$283,420.00
Less Inventory, December 31, 1916.....	54,000.00	
Cost of Goods Sold.....		229,420.00
Gross Profit on Trading.....		\$159,000.00
Discount on Purchases.....	\$1,990.00	
Subrent of Warehouse.....	450.00	
Profit on Consigned Goods.....	2,340.00	4,780.00
Gross Business Profit.....		\$163,780.00

Expenditures

Selling Expenses:

Salaries and Expenses of Salesmen	\$8,890.00	
Wages to Clerks and Packers.....	16,600.00	
Commissions	2,800.00	
Discount on Sales.....	3,460.00	
Warehouse Rent.....	2,500.00	
Warehouse Expenses.....	630.00	
Stable and Delivery Expenses.....	2,300.00	
Freight Outward.....	1,840.00	\$39,020.00

TRADING AND PROFIT & LOSS STATEMENT—*Continued*

General and Administrative Expenses:

Cartage	\$350.00	
Salaries—Office	8,200.00	
Repairs	1,120.00	
Interest on Bank Charges.....	290.00	
Interest on Cancelled Mortgage....	100.00	
Insurance and Taxes.....	320.00	
Donations	230.00	
Office Expense.....	4,600.00	
General Expense.....	3,400.00	
Light and Heat.....	540.00	
Reserve for Bad Debts.....	3,000.00	
Reserve for Depreciation.....	10,660.00	32,810.00

Total Expenses.....		71,830.00
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Net Profit of Business for Year.....		\$91,950.00
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Other Profit and Loss Items:

Profit on Sale of City Property.....	\$1,250.00	
Interest on Investments.....	200.00	
Interest on Investments, Accrued.....	850.00	
		\$2,300.00

Deduct:

Loss on Sale of Securities.....	320.00	
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Profit Outside of Business.....		1,980.00
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Net Profit for Year 1916.....		\$93,930.00
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§ 308. Balance Sheet

BRYANT-CHASE COMPANY

BALANCE SHEET, AS OF DECEMBER 31, 1916

Current Assets:

Assets

Cash	\$17,800.00	
Notes Receivable.....	28,520.00	
Salaries Overpaid.....	200.00	\$46,520.00
Accounts Receivable.....	\$93,410.00	
Less Reserve for Bad Debts.....	3,050.00	90,360.00
		<u>\$136,880.00</u>

BALANCE SHEET—*Continued*

Investments:		
Stocks and Bonds of Other Companies.....		30,000.00
Inventories:		
Merchandise	\$54,000.00	
Goods in Hands of Agents, including Freight		
Charges	2,880.00	56,880.00
Accrued Items:		
Accrued Interest on Investments.....		850.00
Subscriptions to Stock.....		50,000.00
Treasury Stock.....		30,000.00
Fixed Assets:		
Real Estate, Buildings, and Machinery.....	\$210,000.00	
Furniture and Fixtures.....	34,600.00	
Delivery Equipment.....	14,500.00	
	\$259,100.00	
Less Reserve for Depreciation.....	13,800.00	245,300.00
Total Assets.....		<u>\$549,910.00</u>

Liabilities and Capital

Current Liabilities:		
Notes Payable.....	\$38,800.00	
Accounts Payable.....	66,550.00	
Dividend No. 2, payable January 25, 1917....	50,000.00	\$155,350.00
Capital and Undivided Profits:		
Capital Stock Outstanding.....	\$250,000.00	
Capital Stock Subscribed.....	50,000.00	
Working Capital Donated.....	30,000.00	
Undivided Profits, December 31,		
1915	20,630.00	
Net Profit for 1916.....	93,930.00	\$444,560.00
Less Dividend No. 2, payable Jan-		
uary 25, 1917.....	50,000.00	
Company's Net Worth		<u>394,560.00</u>
Total Liabilities and Capital.....		<u>\$549,910.00</u>

STATEMENT OF PERCENTAGES
FOR YEAR ENDED DECEMBER 31, 1916
BASED ON NET SALES

Net Sales.....	\$388,420.00	equals	100%
Gross Profit and Trading.....	159,000.00	"	40.935%
Other Income and Profits.....	6,760.00	"	1.740%
Net Profit.....	93,930.00	"	24.182%
Cost of Sales.....	229,420.00	"	59.065%
Selling Expenses.....	39,020.00	"	10.046%
General and Administrative Expenses....	32,810.00	"	8.447%

§ 309. Closing Journal Entries

The following entries are made on the assumption that a trading or merchandise account is in use and that the beginning and closing inventories were entered therein without journal entries. Instead of posting the totals of the groups to the Trading or Profit and Loss account, it is better to carry the separate amounts. In this way the various items are shown in the Trading account and in the Profit and Loss account, making it easier to compile therefrom the trading and profit and loss statements.

Sales Account.....	\$390,000	
Discount on Purchases.....	1,990	
Subrent of Warehouse.....	450	
Profit on Consigned Goods.....	2,340	
Goods Consigned to Agents.....	14,600	
Rebates and Allowances on Purchases....	1,130	
To Trading Account.....		\$410,510
To close above accounts into Trading account.		
Trading Account.....	\$214,730	
To Purchases		\$210,000
" Freight Inward.....		3,150
" Allowances and Rebates on Sales		1,580
To close above accounts into Trading account.		

Trading Account.....	\$163,780	
To Profit and Loss.....		\$163,780
To close gross trading profit into Profit and Loss account.		

Profit and Loss.....	\$39,020	
To Salaries and Expenses of Sales- men		\$8,890
" Wages to Clerks and Packers...		16,600
" Commissions		2,800
" Discount on Sales.....		3,460
" Warehouse Rent.....		2,500
" Warehouse Expenses.....		630
" Stable and Delivery Expenses...		2,300
" Freight Outward.....		1,840
To close the above selling expenses into Profit and Loss account.		

Profit and Loss.....	\$32,810	
To Cartage		\$350
" Salaries—Office		8,200
" Repairs		1,120
" Interest on Bank Charges.....		290
" Interest on Cancelled Mortgage		100
" Insurance and Taxes.....		320
" Donations		230
" Office Expense.....		4,600
" General Expense.....		3,400
" Light and Heat.....		540
" Reserve for Bad Debts.....		3,000
" Reserve for Depreciation.....		10,660
To close the above general and admin- istrative expenses into Profit and Loss account.		

Interest Accrued on Investments.....	\$850	
To Interest on Investments.....		\$850
To record accrued interest on invest- ments.		

City Property.....	\$1,250	
Interest on Investments.....	1,050	
To Profit and Loss.....		\$2,300
To close the above profits into Profit and Loss account.		
Profit and Loss.....	\$320	
To Securities.....		\$320
For loss on sale of securities closed into Profit and Loss account.		
Profit and Loss.....	\$93,930	
To Undivided Profits.....		\$93,930
To close net profit for year into Undi- vided Profits account, adding it to the former balance of \$20,630.		
Undivided Profits.....	\$50,000	
To Dividend No. 2.....		\$50,000
To record Dividend No. 2 declared by the board of directors December 31, 1916, being 20% of the outstanding capital stock.		

There are, of course, variations of these journal entries that under other conditions may be preferable. The arrangement and allocation of items in the trading and profit and loss statement might, and frequently would, be changed. The final net profit is practically the same in every case.

§ 310. Comments on Closing of Bryant-Chase Company's Books

The manner of closing the books for a trading corporation does not differ from that of the manufacturing corporation.

Attention is called to the accounts peculiar to corporations, such as subscriptions to Stock, Treasury Stock, Capital Stock, Capital Stock Subscribed, and Working Capital

Donated. These are discussed in detail in Chapter VI, "Distinctive Corporate Accounts."

It will be seen that the form of statement differs slightly from that of the Lake Manufacturing Company, preceding. This form is used very extensively by large corporations, and has met with general approval from accountants.

The balance sheet shows a different division of items from that of the Lake Manufacturing Company, simply to indicate the variation in arrangement frequently found in practice. There is no one form that is considered better than all others.

The dividend is deducted from profits and credited to Dividend account, but this is shown only in the balance sheet; it differs slightly from the preceding form. The dividend is not yet payable, but when due the required entries will be made. The percentage statement is brief but shows the manner of setting forth such information. It may be elaborated and extended in any way thought desirable. It is of inestimable value in presenting information pertaining to the rise and fall of results in comparison with previous years.

CHAPTER XXVII

CORPORATE REPORTS

§ 311. Special Reports

In the preceding chapters the discussion has been devoted to the reports and statements as rendered by the accounting department to the corporate officials. In this chapter an attempt will be made to treat briefly the reports as rendered by the officials and the directors to the stockholders, to the public, and to governmental bodies. The scope and content of the reports as outlined are necessarily suggestive but cover in general practically all the important points which they usually take up.

§ 312. Reports to Stockholders

At the annual meeting, it is customary for the directors to give an account of their stewardship for the preceding year, through reports presented by their elected officers. The character of such reports depends upon the size of the company, the nature of the business, and the amount of information which it is wise to disclose. It is obvious that in a small corporation, where the stockholders are in close touch with the management and the business, a report, if made at all, would be merely a brief recital of facts. But in the case of large industrial and public service corporations where the stock is in many hands, it is the practice to prepare an exhaustive annual report which is printed and distributed to the stockholders.

Special reports from officers and committees may be called for at any meeting of stockholders.

§ 313. Reports of Officers and Committees

The following reports may be required at the annual meeting, though it is seldom that all of them will be called for at any one meeting.

1. **Committee Reports.** Under this head come the reports of the various standing committees authorized to take charge of certain parts of the business, as the "Executive Committee" and the "Finance Committee," and of any special committees appointed to act on certain questions or in certain matters.

2. **Auditor's Report.** This report is usually merged into, and becomes part of, the president's or treasurer's report, as its details might well appear in either of these other reports. All accounts and balance sheet items are, in the larger corporations, audited and passed upon by a professional accountant before they are published or presented to the annual meeting.

3. **General Manager's Report.** Gives a detailed review of the general manager's conduct of the business during the year. This report is generally transmitted to the president and through him to the stockholders, either as part of the president's report or in separate form. It is frequently known as the superintendent's report.

4. **Treasurer's Report.** Contains usually a cash statement for the year, statement of earnings and expenses, a general balance sheet, etc. The treasurer's report is frequently incorporated in the president's report.

5. **President's Report.** Reviews the business of the preceding year and sets forth the plans proposed for the coming year. This report usually includes a statement of the gross business done, the net earnings, improvements made, condition of the finances, and the company's property generally, and any other items of interest not covered by other reports.

§ 314. Committee Reports

In the larger corporations there are usually one or more standing committees appointed from the board of directors, such as the executive committee which exercises the general authority of the board in the interim between its meetings, and the finance committee which has general supervision of the financial affairs of the company. The standing committees do not usually report to the stockholders, their reports being made to the board of directors and the matters under their supervision being usually covered by the president's and the treasurer's reports respectively.

Special committees of stockholders are frequently appointed in both large and small corporations. The duties of these special committees are to investigate and report or act upon a special matter assigned them. Where such matters are important or urgent, special meetings of the stockholders might be called to hear their reports; but otherwise these committees would report to the stockholders at the annual meeting.

There is no special form for committee reports. A clear statement of what they have accomplished, addressed to the stockholders or the directors as the case may be, and signed by the members of the committee or by the chairman for the committee, is all that is required.

§ 315. Auditor's Report

The by-laws of a corporation frequently make provision for periodical audits by professional accountants. In some cases auditing committees are appointed by the stockholders or the board of directors to pass upon the books and accounts of the corporation, either independently or in conjunction with professional auditors. In no case, however, should an audit made by a committee of stockholders or directors, be considered an audit in the true sense of the

word. An effective audit requires an examination of the books of account, of the cash, securities, inventory, calculations, etc.; and this necessitates expert work of an accurate, painstaking nature, which can be given only by a professional auditor.

A monthly or quarterly audit or inspection of the accounts by a committee of directors is often made and is to be strongly commended; but the directors are not likely to take the time, or give the effort, or possess the expert knowledge necessary for a really effective audit. Besides this, they cannot always be depended upon to expose or to disapprove of questionable occurrences which have taken place during their period of office and perhaps with their knowledge and concurrence, and it is quite apparent that such audits are not to be given the same weight as would be given the audit of a public accountant.

A complete audit should review all of the business operations of the year; but, since in many cases this requires more time and expense than is thought expedient, an audit is sometimes made in which the examination is restricted to the more important items and accounts. In such cases summaries are compiled, results proved, certain entries vouched, cash inspected, bank balances proved, and perhaps an inspection made of certain items or block of entries throughout the period under review. While a partial audit of this kind is not thoroughly satisfactory, it is frequently deemed sufficient by the corporate officials. In making either a partial or a complete audit, the auditor is expected to see that the books present the true condition of the corporate business; and that the profit and loss statement and balance sheet taken therefrom exhibit, properly arranged, the true results of business operations for the period under review. The auditor is, as a rule, engaged by the directors and reports to them, though not infrequently he is employed by the

stockholders, in which case his report would, of course, go to the stockholders. In either case his report must be unbiased and prepared for the benefit of all concerned. As stated, the auditor's report is frequently utilized for, and more or less completely incorporated in, the reports of the president and the treasurer.

The audit report for a large corporation may include the following:

1. Statement of earnings and operating expenses. This is frequently made in comparative form to show the variation of current income and expenses from those of previous years.

2. Balance sheet. This shows the assets and liabilities of the company properly classified, on the date of closing. It also is frequently given in comparative form.

3. Schedules and statements. These give the supporting details and analysis of the results given in the balance sheet and the statement of earnings and operating expenses.

4. Percentage exhibit. By this exhibit in comparative form, the income, and the operating and administrative expenses based on the sales are shown in comparative form. Such comparisons of amounts can be most readily made by means of percentages.

5. Auditor's certificate. This is a brief certificate certifying to the accuracy of the exhibits and statements.

6. Auditor's general report or letter of explanation. This may be very brief or considerably extended, as the occasion demands. It may contain suggestions or recommendations pertaining to the books and accounts if such are deemed advisable or necessary.*

In some cases the auditor's report is merely a certificate of the correctness of the books and accounts, or of the

*For an exhaustive discussion of audits, see "Auditing—Theory and Practice" by Robert H. Montgomery.

financial statement made to the stockholders, given after an examination of the books. Of this general character is the auditor's certificate which appears in connection with the annual report to stockholders of the United States Steel Corporation. This certificate is as follows:

CERTIFICATE OF AUDITORS

New York, March 8, 1916.

TO THE STOCKHOLDERS OF THE UNITED STATES STEEL CORPORATION:

We have examined the books of the U. S. Steel Corporation and Subsidiary Companies for the year ending December 31, 1915, and certify that the Balance Sheet at that date and the Relative Income Account are correctly prepared therefrom.

During the year only actual additions and extensions have been charged to Property Account, and the provision made for depreciation and extinguishment is, in our opinion, fair and reasonable. The item of Deferred Charges represents expenditures reasonably and properly carried forward to operations in subsequent years.

The valuation of stocks on hand, as shown by inventories certified by the responsible officials, have been carefully and accurately made at approximate cost. Full provision has been made for bad and doubtful accounts receivable and for all ascertainable liabilities.

We have verified the cash and securities by actual inspection or by certificates from the Depositaries, and are of opinion that the Marketable Bonds and Stocks included in Current Assets are worth the value at which they are stated in the Balance Sheet.

We certify that in our opinion the Balance Sheet is properly drawn up so as to show the financial position of the Corporation and Subsidiary Companies on December 31, 1915, and the Relative Income Account is a fair and correct statement of the net earnings for the fiscal year ending at that date.

PRICE, WATERHOUSE & Co.

§ 316. General Manager's Report

The general manager's or superintendent's report will give the important details of his work for the preceding year. It is but seldom that such a report is made direct to the stockholders. The usual course is for the manager or superintendent to hand his report to the president, who may

incorporate it bodily in his report or make such extracts from it as he thinks will be of interest to the stockholders of the company.

§ 317. Treasurer's Report

In many corporations the treasurer makes no independent report, the president's report covering the general affairs and conditions of the corporation together with its finances and plans for the future. This is true, for instance, of the United States Steel Corporation, where but one formal report—that of the chairman of the board—is made to the stockholders. In perhaps the majority of cases, however, the treasurer makes his own report to the stockholders, covering in it such details of the financial affairs of the corporation as the directors deem it expedient for the stockholders to know; or, to express it otherwise, all such financial details as will be of interest to the stockholders, the publication of which will not result in injury to the company's business.

Where but one formal report is made to the stockholders and this report is made by the president, the treasurer or the treasurer's department will, of course, supply the president with material for the financial portion of his statement. In any case, the two officials should work in sufficiently close touch to prevent any serious overlapping of their reports.

The treasurer's report may be informal, merely giving the general results of the year's work; or it may be a more or less detailed statement of the company's financial condition, or may take the form of a complete balance sheet and profit and loss statement. The following from the annual report of the United Fruit Company shows the treasurer's introduction to the detailed exhibits, thus giving an idea as to the scope of the complete report.

TREASURER'S REPORT

TO THE PRESIDENT AND BOARD OF DIRECTORS
OF THE UNITED FRUIT COMPANY:

I hand you herewith statements covering the operations of the company for the fiscal year ended September 30, 1915, together with reports showing its financial condition on that date, viz.:

Income Account
Balance Sheet
Cost of Plantations and Equipment
Live Stock
Area of Owned and Leased Lands
Area of Cultivations
Railways
Steamship Service
Insurance Fund

CHARLES A. HUBBARD,
Treasurer

Boston, December 3, 1915.

§ 318. President's Report

The president's report is usually the most important of those made to the stockholders at the annual meeting. In many cases it is the only formal report. Its contents will vary with the conditions. Where it is the only report, it will cover both the general and financial conditions of the company, as well as any special conditions that are of interest to the stockholders.

The following report is brief but satisfactory. It prefaces a formal balance sheet and income report, and with these constitutes the entire annual report to the stockholders.

TO THE STOCKHOLDERS OF THE
AMERICAN COAL PRODUCTS COMPANY:

The Directors herewith submit for the information of the Stockholders the following financial statements covering the fiscal year ended December 31, 1915:

Against operations for the year 1915 we have written off a sufficient proportion of the cost of our new plants to bring their capital-

ization down to a peace basis. We also instructed all of our subsidiary companies, in making their returns for the year, to charge off doubtful items.

Upon our regular profit-sharing plans and special compensation to all of our wage earners we have provided out of the earnings of the year for the distribution of approximately \$550,000, partly in cash and partly in stock. Every employee of the Company has received some definite benefit from its prosperity.

After deducting the above items the net profit for the year amounts to \$2,902,236.30

Deducting 7% cash dividends on Preferred Stock... 175,000.00

Leaves \$2,727,236.30

This has been apportioned by the Directors as follows:

Dividends on Common Stock:

In Cash, 7%..... \$761,932.50

In Common Stock, 5%..... 538,000.00

Reserves 420,000.00

Surplus 1,007,303.80 \$2,727,236.30

The excess of current assets over current liabilities has increased during the year by..... \$3,389,727.31
and now stands at..... \$8,245,776.93

The \$2,000,000 of notes outstanding a year ago have been paid by an issue of approximately the same amount of Preferred Stock. The Company has now no obligations at any bank, and \$900,000 in marketable securities in excess of ordinary needs.

The name of the American Coal Products Company has been changed to "The Barrett Company" with a similar amount of stock as the American Coal Products Company, and stock certificates are to be exchanged, share for share, in the immediate future, notice of which will be sent to the stockholders shortly.

Appended hereto are Consolidated Income Account for the year 1915 and Comparative Consolidated Balance Sheet as at December 31, 1915 and 1914.*

WILLIAM HAMLIN CHILDS,
President

March 1, 1916

The only formal report presented at the annual meeting of the stockholders of the United States Steel Corporation is

*These statements have been omitted.

a report from the board of directors signed by the chairman of the board. This corresponds to the president's report in other corporations. The report is very comprehensive, covering everything of interest to the stockholders that may properly be disclosed. The heading of this report and a brief statement of the matters discussed appears below.

FOURTEENTH ANNUAL REPORT
TO STOCKHOLDERS OF
UNITED STATES STEEL CORPORATION

Office of United States Steel Corporation,
51 Newark Street, Hoboken, New Jersey,
March 14, 1916.

TO THE STOCKHOLDERS:

The Board of Directors submits herewith a combined report of the operations and affairs of the United States Steel Corporation and Subsidiary Companies for the fiscal year which ended December 31, 1915, together with a statement of the condition of the finances and property at the close of that year.

The report covers:

1. Summary of income for the year.
2. Summary of surplus account.
3. Comparative income for two years—1914 and 1915.
4. Maintenance, renewal, and extraordinary replacements.
5. Bond sinking, depreciation, and extraordinary replacement funds.
6. Summary of depreciation provided from gross earnings.
7. Trustee's account of bond sinking funds.
8. Capital stock, bonded debenture, and mortgage debt.

9. Purchase money obligations, special loans, and notes payable.
10. Summary of inventories.
11. Comparative summary of production for two years—1914 and 1915.
12. Summary of capital expenditure.
13. Employees and pay-rolls.
14. Volume of business.
15. Balance sheet, statements of accounts, and statistics.
16. Comparative general summary of business for two years—1914 and 1915.
17. General information.

The report is followed by a consolidated general balance sheet as of December 31, 1915, together with the consolidated income account and general financial statement of all properties.

The correctness of the financial details of this report is certified to by a prominent firm of accountants, the form of this certificate appearing in § 315.

§ 319. Statutory Corporation Reports

On account of the very great diversity found in the corporation reports required by the various states, no specific discussion of these reports is possible here. All that can be given is a general reference to the reports usually required, the details of which in each state must be found by reference to the authorities by which they are prescribed.

In at least one-half of all the states of the Union, domestic corporations are required to pay an annual tax on the amount of capital stock outstanding and to make a report upon which this tax is based. Corporations holding charters

from other states are required to make returns to both states. Local reports must also be made for purposes of property taxation, by both domestic and foreign corporations. Under the Federal Income Tax Law, all corporations are subject to a tax on their net income, and must make a federal report upon which this taxation is based. Corporations doing business in the United States and Canada are also required to make annual reports to designated state and government officials. Reports from banks and trust companies are required several times each year.

Blank forms for all these reports are usually furnished by the authorities. Foreign corporations generally report on the same blank as domestic corporations, though in some of the states a special blank is provided for their use.

§ 320. The Annual Report

The annual corporation report as required in most of the states sets forth the names of directors, amount of capital, financial conditions, and operations for the past year; and must be filed with the designated state authority, usually the Secretary of State. There is a time specified when reports are to be filed, and a penalty is frequently imposed for failure to file the report within the specified time. Foreign corporations doing business in a state are required to file reports in both the home and the outside state and to comply with the laws of each.

In some states it is required that the annual report be recorded in the county wherein the corporation is located, either in duplicate or on a blank for that particular purpose. Not infrequently, the one report is recorded in both the state and county records, and then returned to the company with certifications of record noted thereon.

In practically all the states, public service companies must make reports of an exhaustive nature, which are re-

quired to be filed once a year or oftener with designated authorities. If there is a public utilities commission in the state, such reports are made to it. Railroad companies doing an interstate business are required to report to the Interstate Commerce Commission.

The annual reports required by some of the states, especially Pennsylvania, are somewhat elaborate. Separate blanks are usually supplied for the different classes of corporations, as public service and insurance companies; while even further divisions are made in some states, where different blanks are used for different kinds of business. This is the case in Pennsylvania, where trading companies, manufacturing companies, hotels, and other kinds of companies report on separate blanks. In most states where reports are to be filed, a penalty is attached to the failure to do so within the time limit designated.

§ 321. Federal Corporation Report

At the present time the Federal Income Tax Law requires every corporation to file with the Collector of Internal Revenue of the district in which the company has its principal place of business, a report of its operations for each calendar or fiscal year. This report is made for the purpose of determining each company's net income for the year, on which the government levies a tax of 2%.* Separate forms are provided in duplicate for the different lines of business, as mercantile, miscellaneous, manufacturing, public service, insurance companies, banks and other financial institutions.

§ 322. Taxable Corporations

Every corporation, joint-stock company, or association, and every insurance company organized in the United States, excepting only the classes of corporations or associa-

*Congress, September, 1916, increased the tax from 1% to 2% on total net income.

tions specially exempted, must pay a tax of 2% on its net income.

Corporations organized or existing under the laws of any foreign country must also pay a tax of 2% on the amount of net income accruing from business transacted and capital invested in the United States. For failure to comply with the provisions of the law, the assessment is increased 50% and liability to specific penalty, not exceeding \$10,000, is incurred. Under both federal and state laws certain corporations and associations are exempted from taxation.

§ 323. Exempted Corporations

The law specifically exempts the following corporations and associations from the payment of the Federal Income Tax:

1. Labor, agricultural, or horticultural organizations.
2. Mutual savings banks not having capital stock.
3. Fraternal beneficiary societies, orders, or associations operating under the lodge system and providing for payment of life, sick, accident, and other benefits to members or their dependents.
4. Domestic building and loan associations.
5. Cemetery companies organized and operated exclusively for the mutual benefit of members.
6. Corporations or associations organized and operated exclusively for religious, charitable, scientific or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual.
7. Business leagues, chambers of commerce, or boards of trade not organized for profit, or no part of the income of which inures to the benefit of private stockholders or individuals.
8. Civic leagues and organizations not organized for

profit, but operated exclusively for promotion of social welfare.

9. Clubs organized and operated exclusively for pleasure, recreation and other non-profitable purposes, no part of the net income of which inures to the benefit of any private stockholder or member.

10. Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or co-operative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting its expenses.

11. Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them.

12. Corporations or associations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title.

13. Federal land banks and national farm-loan associations.

14. Joint-stock land banks as to income derived from bonds or debentures of other joint-stock land banks or any Federal land bank belonging to such joint-stock land bank.

It should be especially noted that in the case of the sixth and seventh classes of corporations above mentioned, the exemption is forfeited if their stockholders or members receive a financial profit from the operations of the corporation or association.

§ 324. Return Made for Either Calendar or Fiscal Year

Every corporation which does not give notice that its fiscal year ends at a date other than December 31, must file a return of its capital stock and indebtedness as of that date and its income for the calendar year, on or before March 1 of the following year. Any corporation whose fiscal year does not coincide with the calendar year will be permitted to file its annual return for its fiscal year instead of for the calendar year, by notifying the collector of the district in which its principal office is located, of the date with which its fiscal year closes. Its return must then be filed within sixty days after the close of its fiscal year. The date designated as the close of the fiscal year must be the last day of a month; and written notice of the selected date must be filed with the local collector not less than thirty days prior to "the first day of March of the year in which its reports would be filed."

Full details respecting the Income Tax Law, its reports, exemptions, withholding of individual income, source, etc., can be had from the internal revenue officer of any local district. The regulations are fully set forth on the blanks themselves.

Part VI—Corporate Combinations

CHAPTER XXVIII

METHODS OF CONSOLIDATION

§ 325. Purposes of Corporate Combinations

The past thirty years have witnessed a wonderful growth in the number and size of business combinations. The movement began among the railroads, but it soon appeared in manufacturing, and more recently it has entered the commercial field. So common are combinations of corporate interests at the present time that nearly all large industrial, transportation, and public service corporations own or control one or more underlying or affiliated companies.

The primary purpose of practically all combinations is to eliminate competition and secure larger profits through the control of prices or rates. It is true, also, that large-scale operation makes it possible to effect economies, to increase efficiency, and to render more satisfactory service. In spite of these advantages, some of which are shared by the consuming public, there has always been more or less hostility toward combinations, due largely to their abuse of the monopolistic powers they usually possess. This hostility has manifested itself in state and federal laws designed to control or prohibit those combinations which are regarded as inimical to the public welfare. Legislation of this kind has limited the

field within which combinations may be formed, and it has also made their formation—even when permissible—somewhat more difficult to effect.

§ 326. Methods of Corporate Consolidation or Control

Besides the legal difficulties in the way of corporate combinations, there are usually other difficulties of a financial or economic character which have to be overcome. To formulate a plan legally and financially possible, and at the same time acceptable to the varying interests of those concerned, is a matter which frequently taxes the ability and ingenuity of those who undertake its consummation.

“Mutual understandings,” “gentlemen’s agreements,” etc., whereby the competing parties agree to divide territory, restrict output, maintain uniform prices, or do other things for their mutual protection; or agreements of competitors to pool their interests and divide the resulting profits, have frequently been tried but rarely with success.

The better and more acceptable methods of consolidating or otherwise bringing corporate interests under a unified control are given below, and most of these methods are illustrated in the succeeding chapters.

1. By Merger. The several consolidating corporations reincorporate under a single charter and become constituent parts of the new company. This plan is practically an outright purchase, as outlined in the next paragraph, except that the purchase under Plan 2 does not necessitate the rechartering of the purchasing corporation. (See Chapter XXIX.)

2. By Purchase. The property and plant of a competitor is purchased outright, and either closed down or continued as a branch of the purchasing company. This

may involve the voluntary dissolution of the selling company. The current assets and liabilities of the selling company may or may not be included in the sale; if not, they must be disposed of preliminary to the company's liquidation. Any bonded liabilities will, of course, follow the plant, or other property, which forms the underlying security. (See Chapter XXIX.)

3. By Lease. The property of one or more competing companies is leased to another company for a stated number of years, very much as one person would lease or rent properties from another. (See Chapter XXX.)

4. By Holding Companies. Usually the holding company is a corporation created for the purpose of dealing in the securities of other corporations, though in some cases one of the consolidating companies, possessing a liberal charter, may be made use of for this purpose. Ownership of a bare majority—sometimes even less than half—of the stock of the competing companies is sufficient for effective control.

The holding company is perhaps the most common form of combination. It is the form to which the name "Trust" is usually applied, because it is really the lineal descendant of the trust or trusteeship organization under which such famous combinations as the Standard Oil Company and the Sugar Trust were first formed. (See Chapter XXXI.)

5. By Parent Companies. Territorial rights or patent rights are sold or leased to operating companies in different localities, these operating companies being first organized by the parent company and sufficient stock being retained in each to insure its control. This is merely a variation of the holding company. (See Chapter XXXI.)

6. By Interlocking Directorates. Under this method, either the same men appear as directors of the different corporations to be controlled, or men representing the interest which controls the allied corporations are so distributed through the various boards of directors as effectually to control the corporate operations. Each company is to all intents and purposes a separate and independent company, the control exercised through its board of directors not affecting its status or its accounting.

§ 327. Expert Investigations

It is customary in any consolidation of large companies to have a careful preliminary investigation of the whole matter by lawyers, financiers, engineers, appraisers, and accountants, and the results of such examinations when properly carried out determine whether or not the proposed plans are feasible or advisable.

The following very excellent discussion of an accountant's investigation for purposes of a merger or other consolidation, covers very completely the details and procedure.

ACCOUNTING INVESTIGATION PRELIMINARY TO CONSOLIDATION*

§ 328. Scope of Investigation

The nature and extent of the accountant's investigation will depend, of course, largely upon his instructions and the conditions; but we will assume that manufacturing concerns in the same line of business contemplate consolidation; that the report of the accountant upon each of the plants is to form the basis of the consolidation,

*The discussion of an accounting investigation which follows is, by permission, taken almost verbatim from "Corporation Accounting and Investigations" by F. H. Macpherson, F. C. A., C. P. A., in the *Journal of Accountancy*, November, 1908.

and that the accountant's instructions are general and not specific; and that they include the determining of the assets and liabilities as well as the earnings.

Accountants differ as to the scope of an investigation. There are those who take the position that the accountant is not expected to make the thorough examination that a regular audit would entail, but that the genuineness of the books and of the balance sheet should be assumed. Most accountants, however, believe that the investigating accountant should analyze the accounts thoroughly, in the doing of which fraud, if any, would be discovered.

Regular audits and special investigations have, or ought to have, the same end in view—the obtaining of a correct statement of facts; and an accountant should not accept and prepare a report from any balance sheet without satisfying himself by a sufficient analysis of the regularity of the accounts, and of the methods followed by which are produced the various items which enter into the assets of a concern, or which go to make up the revenue and expenditure accounts.

§ 329. Report on Assets

Statements covering each of the concerns examined should be included in the report of the accountants independent of each other, and, based upon the specifications which have been set out, should contain information as follows:

1. Assets as of a given date (the same in each instance) divided as to:
 - (a) Realty
 - (b) Plant and machinery
 - (c) Merchandise (raw material)
 - (d) Merchandise (in process)
 - (e) Merchandise (finished product)

- (f) Leasehold
 - (g) Good-will
 - (h) Patents
 - (i) Accounts receivable
 - (j) Bills receivable
 - (k) Cash on hand and in bank
 - (l) Bills receivable under discount (indirect)
 - (m) Accrued interest, insurance, etc.
 - (n) Such other divisions of the assets as the nature of the business may demand
2. Liabilities, as of a given date (the same in each instance), divided as to:
- (a) Bills payable
 - (b) Accounts payable
 - (c) Mortgage indebtedness
 - (d) Bills receivable under discount (indirect)
 - (e) Other indirect liabilities
 - (f) Capital account
 - (g) Such other division of the liabilities as the nature of the business may demand
3. Revenues and expenses. Of each business, showing earning power of each in a given time (usually three years if the business has been in operation so long) and preferably covering the same period.

Taking the items under "Assets" in their order, the accountant will ordinarily not be called upon to verify items "a" to "h"; the land, buildings, stock in trade, leasehold, etc., being specially valued by independent valuers. If not, and these are subject to verification by the auditor, he should in the case of:

- (a) Realty. Call for the title deeds and see that the

account is not charged with fictitious increases in value, or with the annual taxes.

(b) See that a sufficient allowance has been made for depreciation on buildings, etc.

(c, d, e) Merchandise. Raw, in process, and the finished product. Get certified inventories, which should be checked both as to extensions and additions; an independent appraisalment is altogether preferable. Compare inventory with invoices in the case of raw material. To see that profits are not anticipated, a careful inspection of cost accounts is required. In case of manufactured stock care must be exercised to see that office and selling expenses are not prorated and added to the costs of goods appearing in the inventory. Note should be taken of the "dead wood" in the stock and that proper allowance has been made to cover.

(f) Leasehold. Is not usually a consideration, but if found to exist, a special valuation to ascertain present value is best; otherwise, the original cost, less proportionate reduction for the expired period, should be taken.

(g) Good-will. This item can only be determined by agreement between the parties, and is one which does not seriously concern the accountant, except that if it is put in at an arbitrary sum by the vendors, he should see to it that the price be set forth separately and distinctly in the "assets" so that the purchasers may know just how much they are expected to pay.

(h) Patents. See that these are entered at their proper present worth—which will be determined by the remaining life thereof, and the present "state of the art" in that particular connection.

(i) Accounts receivable. A careful examination should be made to ascertain the condition of these, that they are alive and collectible, and that proper provision

has been made for bad and doubtful; also that secreted in the accounts receivable may not be found charges for "goods on consignment" billed out at the usual profit and going to swell the volume of output, thus unduly increasing the earnings by the "anticipation of profits."

(j) Bills receivable. Same examination as in the case of accounts, so far as prospects of realization are concerned.

(k) Cash on hand and in bank. The same verification as in a regular audit.

(l) Bills receivable under discount. This is an indirect asset as well as an indirect liability, and it is important in the case of an amalgamation, where the liabilities are being assumed, that information on this point should be given. It may be necessary that some allowance should be made in anticipation of "loss upon realization."

(m) Accrued interest, insurance, etc. See that the claim for these is fair and proper.

§ 330. Report on Liabilities

Turning next to the question of liabilities, we take up:

(a, b) Bills payable and accounts payable. The verification will be the same as in a regular audit. In this connection it may be proper to say that there is not much danger of the liabilities being overstated. The principal danger lies in the understating or not taking to account of the outstanding liabilities, and this must be carefully guarded against if the transfer of the business involves the assuming of all the liabilities.

(c) Mortgage indebtedness. Verification by the obtaining of a statement from the mortgagees, both as to principal and arrears or accrued interest.

(d) Bills receivable under discount. The remarks

under item "1" in assets would properly apply here, being applicable in both cases.

(e) Other indirect liabilities. These may be in the nature of indorsements (although a strictly improper and illegal proceeding in the case of joint-stock companies), claims for damages, disputed accounts for materials, services or commissions. A distinct statement in writing as to the existence or non-existence of these should be obtained from the proper officers of the company.

(f) The value of the business to the purchasers will be represented by the difference between the assets and liabilities in each case and if profitable should equal the issue of capital stock with an addition to the assets of any undivided profits, which would enhance the value of the equity to be transferred to the amalgamation.

§ 331. Revenue and Expense Accounts

The question of revenue and expenses of operation will in all probability more particularly occupy the attention of the accountant, rather than the ascertaining of the value of the assets and liabilities; in fact, his instructions may limit him to the determining of these without regard to the other. Taking the revenue accounts first: the accountant will require to make a careful investigation of the receipts for the period (usually three years) under examination. He will see that no extraneous revenue has been introduced and that the progress in the revenue account has been consistent and steady, or otherwise. He must be watchful that the revenue account has not been increased by credits for goods "on consignment" with an off-setting entry to accounts receivable.

Other points which require to be looked into are: that goods "on approval" likely to be returned to stock afterwards have not found their way in the sales account;

that fictitious sales, for the purpose of swelling the revenue, have not been put through the books, and shipments not made before close of inventory; that incompleted and unshipped orders have not been credited to sales account, thus inflating revenue by ungained profits; that rebates and allowances are a charge against sales and not an addition to merchandise account. In a word, the *bona fides* of all sales, especially near the end of the period, should be determined to the satisfaction of the accountant.

It is the duty of the accountant to see that all the expenses entered are a proper charge against the business and that they are made within the proper period; that there is no reduction in expenses towards the close of the term under inspection; that the expenses are regular and consistent and bear a steady ratio to the turnover; that proper and reasonable allowances have been made for repairs and renewals, and that these are charged against revenue and not as an increase of capital.

Excessive profits from any particular cause should be noted, as, for instance, those which might arise from the making of heavy purchases in anticipation of an upward tendency in prices, and which anticipation had been fulfilled. He should be satisfied that all profits earned and taken to account are incidental to the business. A sale of real estate not required for the purposes of the business, and made at a substantial profit, forms an example. On the other hand, expenditures of exceptional and unusual character which have gone to reduce the profits below normal should be noted.

§ 332. Cost of Operation

In the consideration of the cost of operation, heed should be given to the effect which a limited capital has had upon the expenses of operation. Lack of capital is

naturally followed by increased borrowings, and increased borrowings augment the interest account. Operation is thus charged with a sum which, had adequate capital been invested, would have been in the nature of a dividend. By way of illustration, take a business in which every dollar of capital invested was borrowed. This may appear an extreme case, but such a business is, nevertheless, sometimes to be found. The borrowed capital is \$100,000. Upon this sum interest is paid out of the business and charged to operating expenses. We are asked to investigate. In the preparation of the profit and loss account we eliminate the \$6,000 interest paid on this sum, in order to arrive at the earning power of the business. It can readily be seen how unfair any other course would have been, and how lack of sufficient capital in any business will impair the earning power and affect the showing as to profits, unless allowance be made therefor. There is no room here for the exercise of a display of good judgment on the part of the auditor in determining what the "adequate capital" should be.

§ 333. Reports and Certificates

Reports in detail upon each business should be prepared and furnished the principals, and these should form the basis upon which the amalgamation is carried out. Regard, of course, will also be had to the introduction of other interests where more extensive operations are contemplated by the amalgamating company.

In addition to the report in detail, a certificate is usually prepared for use in the prospectus. This certificate is generally barren of all information except as to the revenues, expenses of operation, and profit-earning power of the various businesses entering the amalgamation, and these in the aggregate. Indeed, certificates are not un-

common in which information is given only as to the profits earned by the several businesses. It is unusual to see any reference to the amount of capital invested. A model certificate would be one framed somewhat after the following style:

CERTIFICATION

Gentlemen:—I have examined the records of The Brown Manufacturing Company, Limited, and of The Jones Manufacturing Company, Limited, each for a period of three years, and hereby certify to the correctness of the underwritten statements, as to Capital, Earnings, Expenses of Operation, and Net Earnings, covering the period given:

BROWN MANUFACTURING CO., LIMITED

	Net Capital Employed	Earnings	Expenses of Operation	Net Earn- ings
1898.....	\$.....	\$.....	\$.....	\$.....
1899.....				
1900.....				
Total.		\$.....	\$.....	\$.....

JONES MANUFACTURING CO., LIMITED

	Net Capital Employed	Earnings	Expenses of Operation	Net Earn- ings
1898.....	\$.....	\$.....	\$.....	\$.....
1899.....	\$.....	\$.....	\$.....	\$.....
1900.....	\$.....	\$.....	\$.....	\$.....
Total.		\$.....	\$.....	\$.....

COMBINED COMPANIES

	Net Capital Employed	Earnings	Expenses of Operation	Net Earn- ings
1898.....	\$.....	\$.....	\$.....	\$.....
1899.....	\$.....	\$.....	\$.....	\$.....
1900.....	\$.....	\$.....	\$.....	\$.....
Total.		\$.....	\$.....	\$.....

For further information reference is made to my reports in detail herewith.

JOHN THOMPSON,
Accountant

The less detail there is in the report the better, for the obvious reason that much of it would not be understood by the average individual, and the tendency would be to befog rather than enlighten, and that is very undesirable. But an accountant issuing a certificate framed as above, with a simple qualifying reference to a report for further and detailed information, will be placing himself upon safe and sure ground.

CHAPTER XXIX

CONSOLIDATION BY MERGER

§ 334. General Procedure for Merger

When a consolidation is to be effected by merger, the consolidating companies usually form one large corporation. The new corporation becomes the sole legal entity, while the original companies lose their separate existence and are finally dissolved. The merger agreement may stipulate that one or more of the merging companies shall first modify in some way its existing assets or liabilities. Usually, however, the new corporation takes over at once, as far as it legally can, the entire rights, property, privileges, and franchises of the constituent corporations as "going concerns," continuing the business of each, fulfilling all existing contracts, collecting all outstanding claims, and discharging all current liabilities. This is a form of combination that has in many cases proven effective and satisfactory.

The following example illustrates the manner of merging several independent concerns one of which is a partnership. The details and the accounting requirements are taken up in proper sequence. Although this example is made somewhat exhaustive in order to bring out the important points, it is, of course, impossible to present all of the points that may come up in connection with a corporation merger.

§ 335. General Conditions of the Merger

Three corporations and a partnership are to be com-

bined. All are prosperous manufacturing concerns in the same or allied industries. They are to become incorporated under the laws of New Jersey as the "Long-Bain Manufacturing Company" with an authorized capital stock of \$16,000,000, of which one-half is to be common stock, and one-half 7% cumulative preferred stock; par value of shares, \$100 each. There is also to be an issue of first mortgage 5% thirty-year sinking fund bonds of \$5,000,000. They are to be coupon in form and in denominations of \$1,000 and \$10,000, with privilege of registration as to principal.

§ 336. Statement of Concerns to Be Merged

STATEMENT OF MERGING COMPANIES

JANUARY 1, 1916

<i>Assets</i>	Long Company	Bain Company	Vine Company	Bell & Davis	Total
Cash	\$572,800	\$272,500	\$33,800	\$36,100	\$915,200
Notes Receivable..	340,600	135,800	69,100	114,000	659,500
Accounts Receivable	1,021,300	492,750	162,800	82,400	1,759,250
Prepaid Charges...	46,200	38,150	9,200	4,000	97,550
Investments	500,000	150,000	.....	25,000	675,000
Stock and Material.	964,300	510,000	188,800	152,000	1,815,100
Supplies	175,100	51,900	7,800	12,400	247,200
Pledged Securities.	.....	120,000	.....	35,000	155,000
Due from Bain Com- pany	85,000	.....	.....	16,000	101,000
Furniture and Fixtures	125,000	62,000	22,000	14,000	223,000
Patents, Patterns and Tools.....	450,000	244,850	132,500	92,000	919,350
Buildings and Plant	4,390,000	3,359,000	450,000	110,000	8,309,000
Good-Will	1,000,000	.....	250,000	.....	1,250,000
Sinking Fund.....	740,000	.....	.....	.....	740,000
Total	\$10,410,300	\$5,436,950	\$1,326,000	\$692,900	\$17,866,150

<i>Liabilities</i>	Long Company	Bain Company	Vine Company	Bell & Davis	Total
Secured Loans.....	\$.....	\$100,000	\$.....	\$30,000	\$130,000
Notes Payable.....	685,000	270,000	150,000	75,100	1,180,100
Accounts Payable..	350,000	540,000	202,600	205,100	1,297,700
Accrued Charges..	37,900	11,640	8,200	6,200	63,940
Reserve for Depreciation	345,100	120,500	54,000	.....	519,600
Reserve for Bad Debts	10,000	5,310	1,200	1,000	17,510
Reserve for Insurance	105,500	.....	.....	.....	105,500
Mortgage Payable..	.....	300,000	250,000	20,000	570,000
Interest Accrued on Mortgage Payable .....	.....	4,500	.....	500	5,000
Dividend Payable..	230,000	105,000	30,000	.....	365,000
First Mortgage 5% Bonds	2,500,000	.....	.....	.....	2,500,000
Capital Stock.....	5,000,000	3,500,000	600,000	355,000*	9,455,000
Surplus,.....	1,146,800	480,000	30,000	.....	1,656,800
Total	<u>\$10,410,300</u>	<u>\$5,436,950</u>	<u>\$1,326,000</u>	<u>\$692,900</u>	<u>\$17,866,150</u>

Profits for Four Years:

For Year 1912..	\$550,000	\$290,000	\$45,000	\$22,500	\$907,500
1913..	640,000	340,000	71,000	29,500	1,080,500
1914..	680,000	430,000	57,000	26,400	1,193,400
1915..	760,000	370,000	62,000	38,600	1,230,600
Total	<u>\$2,630,000</u>	<u>\$1,430,000</u>	<u>\$235,000</u>	<u>\$117,000</u>	<u>\$4,412,000</u>
Average	<u>\$657,500</u>	<u>\$357,500</u>	<u>\$58,750</u>	<u>\$29,250</u>	<u>\$1,103,000</u>

All the merging concerns have been profitable and the corporations have been paying high dividends. All but the Vine Company have allowed a large proportion of

* Capital to credit of partners at this date.

their profits to remain in the business, and this is also true of Bell & Davis.

§ 337. Terms of Merger

The four concerns sell out to the new company and receive in exchange and in full payment for their respective properties, stock as stated below:

	Preferred	Common	Total
To Long Company.....	\$4,000,000	\$4,000,000	\$8,000,000
To Bain Company.....	2,500,000	2,500,000	5,000,000
To Vine Company.....	450,000	450,000	900,000
To Bell & Davis.....	250,000	250,000	500,000
To the underwriters for services...	100,000	100,000	200,000
	\$7,300,000	\$7,300,000	\$14,600,000
To be sold to the public.....	700,000	700,000	1,400,000
Total authorized issue.....	\$8,000,000	\$8,000,000	\$16,000,000

Each company is to pay any dividends due its stockholders at the date of the merger; it is to liquidate its secured loans, thereby releasing the pledged securities, and then convey the remaining assets and liabilities to the new company in exchange for the stated amounts of the latter's stock. Each company is then to donate to the new corporation for working purposes 10% of the common stock received by it from the new company; and the remainder of the common stock, together with all of the preferred stock received by the corporations, is to be distributed by them among their respective stockholders. When this has been done the companies are to go into voluntary liquidation and surrender their charters.

The good-will allowed to the several concerns in fixing the price to be paid is shown in the following exhibit:

APPORTIONMENT OF GOOD-WILL

(Showing the amount of good-will allowed to each company)

	Long Company	Bain Company	Vine Company	Bell & Davis	Total
Purchase Price....	\$8,000,000	\$5,000,000	\$900,000	\$500,000	\$14,400,000
Former Capital Stock and Surplus (including good- will)	6,146,800	3,980,000	630,000	355,000	11,111,800
Additional Good- Will (included in purchase price)..	\$1,853,200	\$1,020,000	\$270,000	\$145,000	\$3,288,200
Good-Will Formerly on Books.....	1,000,000	.....	250,000	.....	1,250,000
Total Good-Will.	\$2,853,200	\$1,020,000	\$520,000	\$145,000	\$4,538,200

The outstanding bonds and mortgages and accrued interest of the merged concerns are to be redeemed with an equivalent amount of the bonds of the new company; and in the case of the Long Company, in addition a 10% bonus of common stock of the new company is to be given.

The Keystone Trust Company, trustee of the mortgage deed and of the sinking fund of the Long Company, is to act in a similar capacity for the new corporation.

The present sinking fund of the Long Company (\$740,000) is to remain in the hands of the trustee and to become part of the sinking fund of the new corporation. Beginning January 1, 1920, an annual deposit of \$120,000 is to be made to the sinking fund, and a reserve of \$6,000 for premium on bonds purchased by the sinking fund trustee is to be set aside annually out of profits beginning December 31, 1920. The trustee is to have the right to purchase for investment, in the open market, outstanding bonds of the new company at 105 and accrued

interest, at any interest period after January 1, 1922. At the discretion of the directors, the bonds so held by the sinking fund trustee may be cancelled at par on the books of the company or may be permitted to remain therein as an investment.

Of the bonds of the new corporation not required to redeem the outstanding bonds of the merged companies, \$1,000,000 face value have been sold to Mitchell & Stevens, bankers, at 90, payable one-third down and one-third each three months until paid. Preferred stock \$500,000 is sold for cash through Bell Brothers & Company, bankers, with a 50% bonus of common stock, to provide operating capital.

§ 338. Requirements for the Consolidation

From the standpoint of the accountant, the more important matters involved in the Long-Bain consolidation are as follows:

1. The procedure necessary to complete the consolidation and to bring about the dissolution of the existing concerns.
2. The opening entries on the books of the newly incorporated Long-Bain Company, assuming that a new set of books is to be opened, that all assets and liabilities of the Long Company, of the Vine Company, and of Bell & Davis are to be included in the new ledger, and that the books and accounts of the Bain Company will be continued in the branch office.
3. The arrangement for the conduct of the branches, assuming that the plant of the Long Company is to be used as the head office and all the other concerns operated as branches.

4. The closing entries of the Long Company, the Vine Company, and the Bain Company at the time of dissolution and merger.
5. The consolidated balance sheet of the new corporation after all of the preceding requirements have been carried out.

§ 339. Procedure for Consolidation

1. Agreement of Directors. A joint agreement by the directors of each constituent company and the partners of the associated firm must be entered into, fixing the terms of the consolidation.

2. Approval of Stockholders. This joint agreement is then submitted to the stockholders of each company at a meeting called for the purpose, of which due notice must have been given.

3. Application for New Charter. The charter of the proposed Long-Bain Manufacturing Company must be prepared and filed with the Secretary of State of New Jersey, and all other requirements prescribed by the laws of New Jersey must be complied with. The new company may be organized as entirely independent of the consolidated corporations, or the promoters may secure authority to increase the stock of the Long Company from \$5,000,000 to \$16,000,000, and to change its corporate name to the Long-Bain Manufacturing Company.

4. Transfer of Property to New Corporation. All assets and liabilities of the merged concerns must be transferred or assigned to the new Long-Bain Manufacturing Company. Personal properties are conveyed by assignment or bill of sale, and real properties by deed. The bank balance of each concern must be transferred by check. All negotiable papers must be indorsed over to the new company, and official assignment made of other

documents such as insurance policies, contracts, etc. The outstanding mortgages of the dissolving companies are to be exchanged for bonds of the new corporation at par.

5. Surrender of Old Charters. Where the corporations to be taken over are not merged directly in the absorbing corporation, and are not to be kept in existence, application must be made to the state by each corporation for permission to surrender its charter. It is, however, frequently found advisable to keep the charter of "submerged" companies alive in order to prevent competitors from adopting the names and benefiting by their former connections; as an alternative, the names of the merged concerns are sometimes carried on the stationery of the new corporation.

The partnership of Bell & Davis has power either to dissolve or to sell out without asking authority from the state.

6. Issue of Stock and Bonds of New Company. At the time the properties of the old concerns are transferred to the Long-Bain Manufacturing Company, stock and bonds of this company are issued and distributed to the proper persons in accordance with the terms of consolidation. The stock apportioned to each company may be handed over to its directors, and be by them distributed; or certificates may be issued direct to each individual stockholder for the exact amount due to him. Usually a trustee is appointed for this purpose, to whom the separate stockholders deliver or assign their stock in the old corporations in exchange for temporary trust receipts, and to whom the new corporation issues the stock to be exchanged. The trustee then delivers the new stock to its individual owners and surrenders the old stock to the new corporation or retains it for cancellation. The

amount of common stock to be donated back to the new company by each dissolving concern might conveniently be issued by the new company to the trustee in a separate certificate to facilitate the return thereof.

§ 340. Opening Entries on Books of New Corporation

It is desirable to have an entirely new set of books for the newly organized corporation, in order that ample and careful arrangements may be made to accommodate the larger volume of business and the number of accounts that must necessarily follow such an amalgamation of interests. When opening the new ledger care should be taken to arrange the accounts in a systematic manner and to leave sufficient space for each. If a loose-leaf ledger is to be used, this latter precaution will not be necessary.

§ 341. (1) Entries for Issuance of Stock and Bonds

The opening journal entries to record the issue and disposition of the capital stock and to bring the bond issue on the books of the new corporation are as follows:

January 1, 1916

First Entry

Unissued Common Stock.....	\$8,000,000	
Unissued Preferred Stock.....	8,000,000	
To Authorized Capital Stock—Com-		
mon		\$8,000,000
" Authorized Capital Stock—Pre-		
ferred		8,000,000

The Long-Bain Manufacturing Company has been incorporated with a capital stock of \$16,000,000 as shown herewith. It is to take over, as per joint agreement, the assets and liabilities of, and merge, the following concerns, to

which full-paid stock is to be issued in full settlement as shown:

	Preferred	Common
Long Company..	\$4,000,000	\$4,000,000
Bain Company..	2,500,000	2,500,000
Vine Company..	450,000	450,000
Bell & Davis....	250,000	250,000

Total payment	\$7,200,000	\$7,200,000
---------------	-------------	-------------

The remaining stock is to be disposed of as follows:

To the underwriters for services	100,000	100,000
To be sold to the public	700,000	700,000
Total authorized issue.....	\$8,000,000	\$8,000,000

Second Entry

Long Company.....	\$8,000,000	
Bain Company.....	5,000,000	
Vine Company.....	900,000	
Bell & Davis.....	500,000	
To Unissued Common Stock.....		\$7,200,000
" Unissued Preferred Stock.....		7,200,000

For stock issued to the directors of the above-named concerns, as per agreements of merger. The shares are issued at par in full payment for the respective plants and other assets. The shares issued to each company are as follows:

	Preferred	Common
Long Company....	40,000	40,000
Bain Company....	25,000	25,000
Vine Company....	4,500	4,500
Bell & Davis.....	2,500	2,500

Third Entry

Stock Subscription (or The Underwriters)...	\$200,000	
To Unissued Common Stock.....		\$100,000
" Unissued Preferred Stock.....		100,000

For subscriptions to 1,000 shares of common stock and 1,000 shares of preferred, to be paid for in professional services.

This issue of stock might be charged directly to organization expense if desired.

The following entry is necessary to bring the bond issue on the books:

Fourth Entry

Unissued Bonds.....	\$5,000,000	
To First Mortgage Bonds.....		\$5,000,000
Authorization of \$5,000,000 of first mortgage 5% thirty-year sinking fund bonds in denominations of \$1,000 and \$10,000.		

§ 342. (2) Entries for Assets and Liabilities Taken Over

The entries for issuance of stock and bonds are now complete, and the next step is to take over the assets and liabilities of the merging concerns in full payment for their subscriptions. A separate entry is here made for each, though it is obvious that the various assets and liabilities could be amalgamated into one comprehensive entry. In that case the entry would state the aggregate of the items taken over, instead of the separate amounts.

First Entry (Transfer of Long Company's Assets and Liabilities)
Sundry Assets to Sundry Liabilities:

<i>Assets</i>		
Cash*	\$342,800	
Notes Receivable.....	340,600	
Accounts Receivable.....	1,021,300	
Prepaid Charges.....	46,200	

*After the payment of \$230,000 in dividends.

Investments	500,000
Stock and Material.....	964,300
Supplies	175,100
Due from Bain Company.....	85,000
Furniture and Fixtures.....	125,000
Patents, Patterns, and Tools.....	450,000
Buildings and Plant.....	4,390,000
Sinking Fund.....	740,000
Good-Will	2,853,200

Liabilities

Notes Payable.....	\$685,000
Accounts Payable.....	350,000
Accrued Charges.....	37,900
Reserve for Depreciation.....	345,100
Reserve for Bad Debts.....	10,000
Reserve for Insurance.....	105,500
Bonds of Long Company.....	2,500,000
Long Company.....	8,000,000

The above assets and liabilities of the Long Company have been taken over this day at the valuations shown, as per report of the engineers and accountants, in full payment for \$8,000,000 capital stock of this Company, as per order of the directors and agreements previously entered into. An equivalent of common and preferred stock has been issued in exchange therefor, as per agreement.

Total assets.....	\$12,033,500
Total liabilities.....	4,033,500
Capital issued.....	8,000,000

Second Entry (Transfer of Assets and Liabilities of Bell & Davis)

Sundry Assets to Sundry Liabilities:

Assets

Cash*	\$6,100
Notes Receivable.....	114,000

*After payment of \$30,000 secured loans.

Accounts Receivable.....	82,400
Prepaid Charges.....	4,000
Investments	60,000
Stock and Material.....	152,000
Supplies	12,400
Due from Bain Company.....	16,000
Furniture and Fixtures.....	14,000
Patents, Patterns, and Tools.....	92,000
Buildings and Plant.....	110,000
Good-Will	145,000

Liabilities

Notes Payable.....	\$75,100
Accounts Payable.....	205,100
Accrued Charges.....	6,200
Reserve for Bad Debts.....	1,000
Mortgage of Bell & Davis.....	20,000
Interest Accrued.....	500
Bell & Davis.....	500,000
(Full explanation required, as above.)	

The assets and liabilities of the Vine Company are transferred to the books of the new company in like manner after the deduction of the \$30,000 to be paid out in dividends.

As the assets and liabilities of the Bain Company are to be retained and carried in its own ledger, they are not to be taken into the home office accounts. The books of this company are to be kept as heretofore and the only change apparent will be that of ownership, with a reflected increase in capital, surplus, and good-will accounts. The ownership of this branch will be represented in the home office books in a distinguishing account, as "Bain Plant," "Bain Branch," "Investment in Bain Plant," or under some other suitable caption. Since this plant cost \$5,000,000, it will therefore be represented at the same valuation on the new company's books. The entries are as follows:

Bain Plant Investment.....	\$5,000,000	
To Bain Company.....		\$5,000,000
For transfer from Bain Company of all assets, liabilities, etc., valued at \$5,000,000, as per statements on file, in exchange for an equivalent of stock of this Company, as per agreement.		

Certain of the assets of the Bain branch might with advantage be included in the home office accounts (§ 350), in which case the above amount would be correspondingly reduced.

At this time the following entries, which are self-explanatory, might also be made:

Incorporation Expenses.....	\$25,000	
To Cash.....		\$25,000
For incorporation expenses and other charges, including professional services of attorneys and accountants.		

Treasury Stock.....	\$720,000	
To Donated Capital (or Donated Surplus)		\$720,000
The consolidating companies have this day donated to the Long-Bain Company, for working purposes, one-tenth of their holdings of common stock—10% of \$7,200,000 equals \$720,000, entered at par value.		

This transaction should be completed before the final issue of certificates has been made to the various stockholders.

§ 343. (3) Entries for Retirement of Outstanding Bonds and Mortgages of the Merging Concerns

First Entry

Bonds of Long Company.....	\$2,500,000	
Mortgage of Bell & Davis.....		20,000

Interest Accrued.....	500	
Bain Plant Investment.....	304,500	
Mortgage of Vine Company.....	250,000	
To Unissued Bonds.....		\$3,075,000
For refunding of all outstanding bonds and mortgages of the merging concerns, per merger agreement, entry of Bain Plant Investment including mortgage of Bain Company and accrued interest on same \$4,500.		

Since the bonds of the Long Company and the mortgages of the Vine Company and of Bell & Davis, with accrued interest, have been included in the accounts of the new company, they can be readily cancelled by an offsetting entry. This is not true, however, of the mortgage of the Bain Company branch, since all accounts are retained in its own book. The outlay on account of this branch must then be regarded either as an additional expenditure or as an investment therein and charged up accordingly. It can hardly be considered an additional investment in the true sense of the word, since there is an equivalent issue of bond obligations; but the liability is transferred from the branch books to the home office books.

Second Entry

Donated Capital.....	\$250,000	
To Treasury Stock.....		\$250,000
A bonus of donated common stock given to holders of refunded bonds of the Long Company, 10% of \$2,500,000.		

§ 344. (4) Entries Relating to Sale of Securities

First Entry

Incorporation Expenses.....	\$200,000	
To Stock Subscription (or Underwriters)		\$200,000

Being an issue of stock to the underwriters of this Company for services rendered in organizing, and in full payment of their subscriptions:

1,000 shares common.....	\$100,000
1,000 shares preferred.....	100,000

Second Entry

Mitchell & Stevens, Bankers.....	\$900,000	
Discount on Bonds.....	100,000	
To Unissued Bonds.....		\$1,000,000

For sale of \$1,000,000 par of bonds to bankers at 90, payable one-third down and one-third each three months.

Third Entry

Cash	\$300,000	
To Mitchell & Stevens, Bankers.....		\$300,000

First payment of one-third on account of bond sale.

Fourth Entry

Cash	\$500,000	
To Unissued Preferred Stock.....		\$500,000

For sale of \$500,000 par of preferred stock to Bell Brothers & Company, bankers.
Full payment received in cash; 50% bonus of common stock given as entered below.

Fifth Entry

Donated Capital.....	\$250,000	
To Treasury Stock.....		\$250,000

Bonus of common stock given to Bell Brothers & Company, being 50% of cash sale of \$500,000 of preferred stock.

§ 345. (5) Entry in Settlement of Intercompany Obligations

The following entry in settlement of intercompany obligations would be made as soon as the Bain plant is

in a position to spare the cash. This indebtedness could have been, and usually is, settled before making the transfer; otherwise it could be included in the regular personal accounts.

Cash	\$101,000	
To Due from Bain Company.....		\$101,000
To settle claims owing by the Bain Com- pany at time of amalgamation, and which were carried into the accounts of this Company as follows:		
Owing to Long Company.....	\$85,000	
Owing to Bell & Davis.....	16,000	

There is nothing special to be done with the sinking fund at this time, and it will stand on the books of the new corporation as it formerly stood on the books of the Long Company, until additional instalments are deposited therein. All interest accumulations thereon must, of course, be added from time to time as they are reported by the trustee. It will be noted that the trustee has authority to use the sinking fund for the purchase of outstanding bonds of the company.

In anticipation of the bond redemption at 105, the company is to begin, on January 1, 1920, to set aside out of profits an annual reserve of \$6,000 to offset bond premium, which may be credited to Reserve for Bond Premium. When the bonds are called at a premium, such premium is charged against the reserve.

§ 346. The Conduct of the Branches

There are two main systems of conducting branch houses: in the one, all accounts are kept in the books of the home office and all collections are made therefrom, all business transacted at the branches being reported daily to the home office; in the other, all accounts and records

are kept at the branch offices and reports are made to the home office from time to time.

As all the assets and liabilities of the Vine Company and of Bell & Davis have been taken onto the home office books, it may be assumed that these branch offices are to be handled under the first plan—practically as selling agencies. It is evident that the Bain plant is to be handled under the second plan, the assets and liabilities being continued in its own ledgers and its own complete set of books being maintained as before. Therefore, any adjustments necessary in the transfer of ownership and liquidation of certain liabilities must necessarily be made in these books. This branch will keep all accounts pertaining to its business affairs and report periodically to the home office.

In the Vine Company and Bell & Davis offices, triplicate copies will be made of each invoice; the original will be given to the customer, the duplicate forwarded to the home office, and the triplicate kept on file at the branch. A like plan is followed in connection with all other transactions, thus enabling the home office to record each day the various sales, purchases, and expenses of these branches.

Cash or merchandise sent from the home office to the branches is charged to them, and remittances of cash or merchandise from the branches to the home office are credited to the branches. Goods or cash sent from one branch to another must, of course, be reported to the home office promptly so that interbranch debits and credits may be made.

Since the office of the Long Company becomes the head office, no material changes are necessary in its methods of account-keeping, though a new general ledger is assumed to have been opened.

§ 347. Closing Entries for Long Company

In these illustrative entries many of the details and computations used in arriving at results are omitted. They are usually all proved by the accountant, however, in his working papers and can be referred to at any time during the process of consolidation.

First Entry

Dividend Payable.....	\$230,000	
To Cash.....		\$230,000
For payment of dividend due today.		

Second Entry

Good-Will	\$1,853,200	
To Surplus.....		\$1,853,200
This Company has agreed to merge with and sell out to the Long-Bain Manufacturing Company for \$8,000,000, as per agreement executed this day, and as per order of the directors. The good-will allowed in addition to the \$1,000,000 already on the books is \$1,853,200.		

Third Entry

Long-Bain Manufacturing Company.....	\$12,033,500	
To Sundry Assets:		
Cash		\$342,800
Notes Receivable.....		340,600
Accounts Receivable.....		1,021,300
Prepaid Charges.....		46,200
Investments		500,000
Stock and Material.....		964,300
Supplies		175,100
Due from Bain Company.....		85,000
Furniture and Fixtures.....		125,000
Patents, Patterns and Tools.....		450,000
Building and Plant.....		4,390,000
Sinking Fund.....		740,000
Good-Will		2,853,200

For all assets turned over in payment of subscription to \$8,000,000 of stock, as per resolution of the directors and stockholders.

Fourth Entry

Sundry Liabilities:

Notes Payable.....	\$685,000	
Accounts Payable.....	350,000	
Accrued Charges.....	37,900	
Reserve for Depreciation.....	345,100	
Reserve for Bad Debts.....	10,000	
Reserve for Insurance.....	105,500	
First Mortgage Bonds.....	2,500,000	
To Long-Bain Manufacturing Com- pany		\$4,033,500
For all liabilities of Long Company as- sumed by the Long-Bain Company as per agreement.		

Fifth Entry

Stock of Long-Bain Manufacturing Com- pany	\$8,000,000	
To Long-Bain Manufacturing Com- pany		\$8,000,000
For \$8,000,000 of the capital stock of the Long-Bain Manufacturing Company received this day, as per agreement, in full payment for plant, assets, and liabilities turned over and transferred according to legal requirements:		
40,000 shares common stock	\$4,000,000	
40,000 shares preferred stock	4,000,000	
Total.....	<u>\$8,000,000</u>	

Sixth Entry

Surplus	\$400,000	
To Stock of Long-Bain Manufactur- ing Company.....		\$400,000

For donation of 10% of the allotment of \$4,000,000 common stock, to be used by the Long-Bain Company for working purposes.

Seventh Entry

Capital Stock	\$5,000,000	
Surplus	2,600,000	
To Sundry Stockholders.....		\$7,600,000
For allotment of stock of the Long-Bain Company to the individual stockholders in proportion to holdings.		

The distribution of stock must, of course, be made in the proportion decided upon by the stockholders themselves, and it is evident that uneven amounts of both classes of stock will obtain. In some cases to make an equitable adjustment, money will have to be passed for the equalization of shares.

Eighth Entry

Sundry Stockholders.....	\$7,600,000	
To Stock of Long-Bain Manufacturing Company.....		\$7,600,000
For distribution of the common and preferred stock of the above company in accordance with allotment agreement.		

§ 348. Closing Entries for Vine Company; Bell & Davis

Similar adjusting and closing entries are required on the books of the Vine Company, setting up the necessary accounts for clearing the transaction and distributing the newly acquired stock.

Closing entries for Bell & Davis are similar to those given in §§ 167-169.

§ 349. Closing Entries for Bain Company

Since the operating accounts of this company are to

remain on the books of the branch, it is manifest that only certain adjusting entries are necessary at this time. They are as follows:

First Entry

Good-Will	\$1,020,000	
To Surplus.....		\$1,020,000
For sale value of plant and net worth in excess of present book value. (Full explanation here.)		

Second Entry

Dividend Payable.....	\$105,000	
To Cash.....		\$105,000
For payment of dividend due today.		

Third Entry

Secured Loans.....	\$100,000	
To Cash.....		\$100,000
For payment of secured loans.		

Fourth Entry

Investments	\$120,000	
To Pledged Securities.....		\$120,000
For return of pledged securities upon payment of loan.		

Fifth Entry

Stock of Long-Bain Manufacturing Com- pany	\$5,000,000	
To Long-Bain Manufacturing Com- pany		\$5,000,000
For common and preferred stock of the Long-Bain Company received in full payment for plant, assets, and liabili- ties:		
25,000 shares common....	\$2,500,000	
25,000 shares preferred....	2,500,000	
Total.....	\$5,000,000	

Sixth Entry

Surplus	\$250,000	
To Stock of Long-Bain Manufactur-		
ing Company.....		\$250,000
For donation of 2,500 shares common		
stock back to the Long-Bain Company		
for working purposes.		

Seventh Entry

Capital Stock.....	\$3,500,000	
Surplus	1,250,000	
To Sundry Stockholders.....		\$4,750,000
For allotment of stock in the new cor-		
poration, in proportion to holdings.		

Eighth Entry

Sundry Stockholders.....	\$4,750,000	
To Stock of Long-Bain Manufactur-		
ing Company.....		\$4,750,000
For distribution of stock, as per agree-		
ment of adjustments.		

Ninth Entry

Mortgage Payable.....	\$300,000	
Interest Accrued.....	4,500	
To Long-Bain Manufacturing Com-		
pany (Home Office).....		\$304,500
For payment of mortgage and accrued		
interest by the Long-Bain Company		
by an equivalent exchange of 5% bonds.		

Tenth Entry (For payment of interbranch obligations when cash is ample, as per agreement)

Accounts Payable.....	\$101,000	
To Cash.....		\$101,000
Payment of accounts due:		
Long Company.....	\$85,000	
Bell & Davis.....	16,000	

§ 350. Balance Sheet of Bain Branch

The ledger accounts maintained on the Bain branch

books are reflected in the accompanying balance sheet, showing the proprietorship interest of \$5,304,500 standing to the credit of the Long-Bain Manufacturing Company. Certain of the assets could, with some advantage, be transferred to the home office books and removed from the branch ledger, such as the investments, buildings and plant (particularly the real estate). Depreciation reserve and good-will might also be transferred. This would leave only working accounts on the branch ledger, and a credit of \$776,000 to the home office account. The accountant must, of course, suit his entries to existing conditions.

BALANCE SHEET OF THE BAIN BRANCH

(After sale to the Long-Bain Company, showing open ledger accounts.)

Cash	\$67,500.00	Notes Payable.....	\$270,000.00
Notes Receivable ...	135,800.00	Accounts Payable*...	540,000.00
Accounts Receivable.	492,750.00	Accrued Charges....	11,640.00
Prepaid Charges.....	38,150.00	Reserve for Depre-	
Investments	270,000.00	ciation	120,500.00
Stock and Material..	510,000.00	Reserve for Bad	
Supplies	51,900.00	Debts	5,310.00
Furniture and		Long-Bain Company	
Fixtures	62,000.00	Home Office Ac-	
Patents, Patterns, and		count	5,304,500.00
Tools	244,850.00		
Buildings and Plant..	3,359,000.00		
Good-Will	1,020,000.00		
	<u>\$6,251,950.00</u>		<u>\$6,251,950.00</u>

§ 351. Consolidated Balance Sheet of New Corporation

The consolidated balance sheet which follows is practically a trial balance of the ledger accounts after the incorporation of the new company.

* Intercompany obligations of \$101,000 included, not to be paid until cash is ample.

CONSOLIDATED BALANCE SHEET
OF THE LONG-BAIN MANUFACTURING COMPANY
AS OF JANUARY 1, 1916
(After Incorporation and Merging)

<i>Assets</i>	<i>Liabilities and Capital</i>
Cash \$1,228,700.00	Notes Payable..... \$910,100.00
Notes Receivable... 523,700.00	Accounts Payable.. 757,700.00
Accounts Receivable. 1,266,500.00	Accrued Charges... 52,300.00
Prepaid Charges.... 59,400.00	Reserve for Depreciation 399,100.00
Investments:	Reserve for Bad Debts 12,200.00
Bain Branch Plant 5,304,500.00	Reserve for Insurance 105,500.00
Stock of Other Companies 560,000.00	Donated Capital.... 220,000.00
Stock and Material. 1,305,100.00	First Mortgage Bonds 5,000,000.00
Supplies 195,300.00	Authorized Capital Stock Preferred.. 8,000,000.00
Furniture and Fixtures 161,000.00	Authorized Capital Stock Common... 8,000,000.00
Patents, Patterns, and Tools..... 674,500.00	
Buildings and Plant. 4,950,000.00	
Sinking Fund Trustee 740,000.00	
Incorporation Expenses 225,000.00	
Discount on Bonds. 100,000.00	
Treasury Stock.... 220,000.00	
Unissued Bonds.... 925,000.00	
Unissued Preferred Stock 200,000.00	
Unissued Common Stock 700,000.00	
Mitchell & Stevens, Bankers 600,000.00	
Good-Will* 3,518,200.00	
<u>\$23,456,900.00</u>	<u>\$23,456,900.00</u>

*Comprising the good-will of the Long Company, the Vine Company, and of Bell & Davis. The good-will of the Bain Company is included in the account of the Bain branch plant, shown under "Investments."

§ 352. Consolidation by Purchase

Under this plan of merger (§ 326), one company purchases outright the properties of one or more companies. The general plan and the book entries involved do not differ materially from those already fully explained under consolidation by merger, except that in an outright purchase there need not be any application to the state other than for dissolution of the selling companies. They surrender their charters to the state according to prescribed legal procedure.

CHAPTER XXX

CONSOLIDATION BY LEASE

§ 353. Leases

A common method of securing control of a competing concern is to rent its plant or property for a term of years—a plan extensively used by transportation companies to gain possession of connecting lines. By this method competition is eliminated and the lessee company obtains valuable connections and a going business without incurring the cost and delay of building operations. The lessor, on the other hand, besides being relieved of the operation of its properties, may receive more satisfactory returns in the form of rentals.

Leases commonly run from 1 to 50 years, but may extend to 99 years, and occasionally to 999 years; such a lease is equivalent to permanent ownership, so much so that the operating company may improve the properties without any hesitancy. Short term leases usually include the option of a renewal on the same or on specified terms. The lessor company, as a rule, continues to maintain its separate existence, but its activities consist merely in receiving and disbursing moneys in the form of expenses, dividends, etc.

Nearly all leases require the operating company to pay taxes, insurance, and up-keep expenses of the leased properties, and to undertake other obligations of a more or less rigid nature. In mining operations the terms of the lease usually require the payment of a certain amount per ton on the output of ore, with a specified minimum

output, while in the case of a railroad or similar property the payment is likely to be a specified rental or a guaranteed dividend on the lessor's outstanding stock, with perhaps some participation in profits.

The lessor is given access to the accounts and records of the lessee as far as they relate to the leased property during the life of the lease. Leases of large properties are usually matters of public record and the details thereof accessible to the public.

§ 354. Entries for Property Leased

Leased properties continue in the ownership of the lessor and must be returned at the expiration of the lease. Where the properties taken over are of such a nature that they are merged and perhaps consumed, as for instance, equipment and supplies, the lessee usually absorbs them into its own accounts and at the expiration of the lease either pays for them in cash or returns other equivalent assets. The assets so absorbed may be charged to the property accounts already in the ledger and credited to the lessor, or else be charged to separate accounts.

The record of leased property stands as entered until the lease expires, while repairs and minor improvements on the property are usually charged to operating expenses. Permanent improvements would usually be charged against the lessor, the matter being determined by the terms of the lease. On the balance sheet, leased properties and the owner's credits may appear among the assets and liabilities as cancelling amounts, or may be entered on both sides "in short," in order to indicate their relation to other items; or they may be mentioned in a footnote to the balance sheet, or even be omitted entirely. If they are merged and included in the lessee's properties, a footnote may or may not be necessary, but

in that case the lessor's account must be included in the liabilities.

Corresponding, though reverse, entries should be made on the books of the lessor for the properties conveyed by the lease, in case it is decided to make book entries at all. It would seem good practice to debit the leasing company and credit the property leased, but, if all the property owned by the lessor is taken, there would be nothing gained by so doing. This entry would, of course, be suitable where only a part of the property is conveyed, in order to distinguish between properties leased to others and properties operated.

§ 355. Entries for Guarantees

When guarantees of interest or dividends are included in the terms of a lease, book entries are not absolutely necessary to record the contingent liability incurred; and yet it is good business practice so to record such liabilities as to keep the obligation continually before the stockholders.

The Pennsylvania Railroad Company does not enter such guarantees in its ledger accounts, but in its annual report a complete list of them is included. If book entries are made for guarantees, they must obviously be for record only, because as contingent entries they would offset each other in the accounts. In the annual balance sheet they should be exhibited either among the accounts (in short or otherwise), or as a footnote thereto.

§ 356. Lease Terms

To illustrate the entries required when properties are leased by a corporation, assume that the Vermont Mining and Smelting Company has leased a mine from the Union Mining Company for a term of thirty years. The prop-

erties taken over comprise the mine, valued at \$400,000, buildings and equipment valued at \$30,000, and supplies valued at \$8,500. At the termination of the lease the properties are to be returned to the Union Mining Company in as good condition as when taken over, except as to the ore mined. The Vermont Mining and Smelting Company agrees to pay as rental for the mine a guaranteed annual dividend of 4% on the Union Mining Company's capital stock of \$1,000,000 during the life of the lease, and a royalty of 10 cents per ton for every ton of ore mined.

The Vermont Mining and Smelting Company leases also a short railroad and its equipment, valued at \$3,000,000, of the Wilson Transportation Company. The lease is to run for thirty years, at the end of which time the property is to be returned in good condition. The lessee is to guarantee during the existence of the lease an annual dividend of 6% on the capital stock (\$2,000,000) of the lessor company as rental, and is in addition to pay all taxes, improvement expenses, and interest on the outstanding bonds, and to make all needed replacements.

The Vermont Company finds it necessary to expend for improvements on the Union Mining Company property \$100,000, and on the railway \$400,000; and in order to secure funds for this, the company issues \$500,000 of short term notes payable \$100,000 each year for five years and drawing 6% interest. The notes are secured by a deposit with the trustee of \$500,000 stock of the Lone Ridge Mines Company, a successful subsidiary. The notes are sold at 95 to a banking firm.

The output of ore from the leased mine during 1916 is 122,000 tons, and the net income therefrom to the lessee after paying operating and repair expenses is \$85,000, out of which the rental must be paid. The Union Mining Company is able, out of the rental received, to

apply 3% of the value of the mine leased on its extinguishment fund and also to apply to the dividend fund 2 1/2% on its capital stock.

The operations of the leased railway for the year are shown in the following summary:

Gross Freight Earnings.....		\$750,000.00
Operating Expenses.....	\$230,000.00	
Replacements and Repairs.....	145,800.00	
Improvements, etc., charged off.....	14,000.00	
Guaranteed Dividend to Lessor.....	120,000.00	509,800.00
Net Earnings.....		\$240,200.00

The accounting procedure to be considered in connection with the foregoing transactions involves entries for:

1. Lease of the mine and equipment.
2. Lease of the railway and equipment.
3. Issue of notes and expenditures for improvements on leased properties.
4. Distribution of rentals of leased properties at end of first year.
5. Union Mining Company at the beginning and end of the first year.
6. Wilson Transportation Company at the end of the year's operations under the lease.

§ 357. Entries for Lease of Mine

It is natural to suppose that the lessee will aim to secure from the mine during the life of the lease, all of its ore, unless the lease contains some limitations. The outlay for improvements and extensions made by the lessee must be written off during the life of the lease as operating expenses, excepting as to any movable equipment belonging to the lessee. The mine buildings and equipment are

valued at \$30,000, and must be returned when the lease expires. The supplies taken over are valued at \$8,500, and must be made good when the lease expires. Assuming that the Vermont Company decides to bring these properties into its own accounts, the following entry is made:

Leased Properties of Mining Company.....	\$438,500
To Union Mining Company for Leased Properties	\$438,500
For mine, valued at \$400,000, buildings and equipment at \$30,000, and supplies at \$8,- 500, taken over under thirty-year lease, to be returned at expiration thereof.	

It will be seen that one entry offsets the other. They must stand thus in the ledger accounts until the lease matures and then be eliminated by a counterbalancing entry.

Under an alternative plan that is also good practice, no entry in the books is necessary for the leased properties, save the record of the transaction in the minutes of the directors and stockholders.

The improvements on the mining property, costing \$100,000, should be charged to "Improvements Account of Union Mine," and then written off one-thirtieth each year during the life of the lease. Any improvements of succeeding years may be spread over the remaining years of the lease's existence. Expenditures for the up-keep of buildings and equipment, replacements and supplies, should be charged like the regular company expenses to Operating Expense account.

§ 358. Entries for Lease of Railway

The same general accounting procedure may be followed for the leased railway property as for the leased mine. Both road and equipment must, of course, be kept

in good condition during the tenure of the lease. The value of the road taken over may or may not be entered upon the books of the lessee, but it is advisable to enter the equipment. All expenditures for extensions or improvements must obviously be spread over the life of the lease; while up-keep and operating expenses are considered as current charges. The guaranteed 6% dividend of \$120,000 per year should also be considered a charge against operations.

Leased Equipment of Wilson Transportation

Company \$.

To Wilson Transportation Company,

Leased Equipment.....

\$.

For equipment taken over under lease, to
be returned at the expiration thereof
(full details).

It is probable that rolling stock and any other properties of the lessee company used in the operation of the railroad property will be transferred to the leased road, and then taken back at the expiration of the lease.

§ 359. Entries for Improvements and Note Issue

The expenditures for improvements on leased properties should be charged against the improvement accounts of the respective properties in order to keep the different expenditures separate and distinct. The security back of the note issue should be listed separately in the explanation of the journal entry, or else a notation should be made stating the disposition of the collateral. Everything must be so recorded as to be clearly understood. Interest on the notes and the amortization of bond discount must be charged each year as operating expenses of the business. The recording entries may be as follows:

Cash	\$475,000	
Bond Discount.....	25,000	
To Collateral Serial Notes.....		\$500,000
For sale to bankers at 95 of \$500,000 of short term 6% notes, payable \$100,000 each year for five years, secured by a deposit with the trustee of \$500,000 stock of the Lone Ridge Mines Company.		
Pledged Securities for Serial Note Issue.....	\$500,000	
To Stocks of Other Companies.....		\$500,000
(Full explanation required here.)		
Union Mine Improvements.....	\$100,000	
Wilson Railway Improvements.....	400,000	
To Cash.....		\$500,000
(Full explanation required here.)		

§ 360. Adjusting Entries at End of First Year

The entries which follow indicate adjustments at the end of one year on the books of the Vermont Mining and Smelting Company. Only such entries are shown here as affect the accounts of the properties leased; interest on bonds, etc., being omitted.

December 31, 1916

Union Mine Operating Account.....	\$3,500.00	
Wilson Railway Operating Account.....	14,000.00	
To Union Mine Improvements.....		\$3,333.33
" Wilson Railway Improvements....		13,333.33
" Bond Discount.....		833.34
To write off 1/30 of improvements and bond discount in proportion to the improvements, 1/5 and 4/5, as follows:		
Improvements cost.....	\$500,000	
Bond discount.....	25,000	
Total.....	\$525,000	

Union Mine Operating Account.....	\$52,200	
To Union Mining Company.....		\$52,200
For royalties and guaranteed dividends on leased mine for 1916, as per terms of lease, being 10 cents per ton on 122,000 tons ore mined, \$12,200, and 4% dividend on \$1,000,000 of capital stock, \$40,000.		

Wilson Railway Operating Account.....	\$120,000	
To Wilson Transportation Company....		\$120,000
For application of guaranteed 6% dividend on company's outstanding stock after pay- ment of taxes, improvements, operating repairs, etc., according to the terms of the lease. 6% on \$2,000,000 capital stock = \$120,000.		

Union Mining Company.....	\$52,200	
Wilson Transportation Company.....	120,000	
To Cash.....		\$172,200
For payment of royalties and dividends for leased properties, as per statement.		

Union Mine Operating Account.....	\$29,300	
Wilson Railway Operating Account.....	240,200	
To Profit and Loss.....		\$269,500
For net earnings after paying royalties and guaranteed dividends as per agreement.		

§ 361. Entries for Union Mining Company

There may or may not be entries made on the books of the lessor company at the time of executing the lease. The following entries are suggestive, though a different plan might be followed. Only the accounts affected by the lease are included in the entries, no attention being given to accruals or intermediate entries.

Entry when lease is made:

January 1, 1916

Properties Leased to Vermont Mining and Smelting Company.....	\$438,500	
To Mining Property.....		\$400,000
" Buildings and Equipment.....		30,000
" Supplies		8,500
For lease of properties to Vermont Mining and Smelting Company as per terms of the lease (full explanation).		

Entries at end of first year:

December 31, 1916

Cash	\$52,200	
To Income Account.....		\$52,200
Income from mine and properties leased to Vermont Mining and Smelting Company, as per terms of the lease:		
122,000 tons of ore mined, at 10 cents per ton.....	\$12,200	
Guaranteed dividend on capital stock	40,000	
Total rental for year.....	\$52,200	

Income Account.....	\$52,200	
To Extinguishment of Mines Reserve..		\$12,000
" Dividend Account.....		25,000
" Profit and Loss.....		15,200
For disposition of income from leased properties.		

§ 362. Balance Sheet of Union Mining Company

The balance sheet of the Union Mining Company at the end of the first year, December 31, 1916, would appear as follows:

UNION MINING COMPANY

BALANCE SHEET, DECEMBER 31, 1916

(One year after properties were leased to the Vermont Mining and Smelting Company)

<i>Assets</i>	<i>Liabilities</i>
Mines, Buildings, and Real Estate..... \$430,000.00 Properties Leased to Vermont Mining and Smelting Company.. 438,500.00 Supplies and Fixtures. 77,000.00 Inventory of Ore at Mines and Docks.... 254,600.00 Accounts Receivable.. 318,250.00 Cash 377,520.00 Prepaid Charges..... 36,146.00 Incorporation Expenses, Balance 23,200.00	Mortgage Payable..... \$150,000.00 Temporary Bank Loans 75,000.00 Accounts Payable..... 231,450.00 Accrued Pay-Roll..... 17,240.00 Accrued Charges and Interest 26,385.00 R e s e r v e for Extin- guishment of Mines. 12,000.00 Reserves for Sundry Purposes 57,936.00 Dividend Account.... 25,000.00 C a p i t a l Stock Out- standing 1,000,000.00 Surplus 360,205.00
<u>\$1,955,216.00</u>	<u>\$1,955,216.00</u>

NOTE: Net income from leased properties, \$52,200, applied to reserve for extinguishment \$12,000, to Dividend account \$25,000, and to Surplus \$15,200.

§ 363. Entries for Wilson Transportation Company

Since all of the property, road bed, and equipment of the railway has been leased to the Vermont Mining and Smelting Company, it is apparent that no separate entries are necessary in the accounts of the Wilson Transportation Company. The property accounts stand as they are on the books, representing as they do the investment therein. At the end of the year, however, entries must be made in the books to record the dividends guaranteed by the Vermont Mining and Smelting Company.

December 31, 1916

Cash	\$120,000	
To Income Account.....		\$120,000
Being guaranteed income from road and equipment leased to Vermont Mining and Smelting Company, as per terms of the lease.		
Income Account.....	\$120,000	
To Dividend Account.....		\$120,000
For dividend guaranteed by the lessee, Ver- mont Mining and Smelting Company, payable January 25, 1917.		

CHAPTER XXXI

HOLDING COMPANIES

§ 364. Classification of Holding Companies

The holding company is a corporation formed for the purpose of purchasing the securities of other corporations. It furnishes an effective method for the consolidation of various companies engaged in the same or related lines of business, and the elimination of competition.

Holding companies may be divided into two classes:

1. Those organized to control other companies in similar or associated enterprises, by purchasing a controlling interest in the stock of such companies.
2. Those formed to invest capital in the securities of other companies, though not necessarily to the extent of securing control; such investments may be spread over non-competitive lines of industry, and may include bonds as well as stock.

§ 365. Controlling Corporations

Where the state laws permit, any company whose charter so provides, may purchase the stocks and bonds of other companies. A company may therefore be both an operating and a holding company. For the purpose of securing control of another corporation, it is customary to purchase at least 51% of its outstanding stock having voting rights, though sometimes a much smaller propor-

tion may be sufficient for effective control. It has been stated by high authority that 33% of its stock is sufficient to control almost any important railway, owing to the wide distribution of the securities of such companies. There are many instances where the management of banks and industrial companies has been maintained by a unified minority.

§ 366. Status of the Subsidiary Company

The sale of the stock of a company to a holding company in part, or even in whole, does not necessarily affect its accounting, save as to the record of stock transferred. Nor is its legal status changed in any way, though it may, as a matter of fact, have become a subsidiary under the control of the holding company. The most notable example of holding and subsidiary companies is perhaps found in the case of the United States Steel Corporation which is not an operating company. All dividends declared by the constituent or operating companies are paid to their own stockholders; and the holding company, though controlling these constituent companies, benefits by such dividends only as a stockholder and to the extent of its holdings of their stock.

§ 367. Legality of Holding Companies

Many states prohibit the organization of holding companies, while others afford especially favorable facilities for their formation. A holding company may be incorporated in a state which permits such incorporation, and then lawfully conduct operations through its constituent companies within states prohibiting its existence. The laws of Missouri, for instance, prohibit holding companies, while the laws of New Jersey permit them; and, as a company organized in one state may by comity do business

in another, a holding company organized in New Jersey may carry on operations through its constituent companies in Missouri. For this and other reasons federal control of combinations has been advocated.

In 1890 Congress passed the Sherman Anti-Trust Act, under which every contract or combination in restraint of trade is declared illegal. Under its provisions some of the largest combinations have already been dissolved. By the passage of the Clayton law in 1914, Congress has undertaken to control more effectively such combinations as come within federal jurisdiction.

§ 368. Accounting Procedure of Holding Company

The example which follows shows the accounting procedure involved where a corporation has been organized for the sole purpose of purchasing the stocks and bonds of other companies.

The Harlow Manufacturing Company was incorporated July 1, 1916, for the purchase of stocks and bonds of other established companies as a means of providing income and of harmonizing conflicting interests. The capital stock is \$1,000,000, composed of 10,000 shares of the par value of \$100 each, and \$950,000 of this capital stock has been subscribed and paid in. Incorporating expenses amount to \$10,000. The proceeds from the stock subscriptions have been used for the purchase of securities as of July 1, 1916, as follows:

- | | |
|---|-------------|
| 1. \$100,000 of 5% first mortgage bonds of the Vulcan Iron Works at 95 and accrued interest for three months.... | \$96,250.00 |
| 2. \$200,000 of refunding 5% first mortgage bonds of the Rapid Transit Corporation at 98 and accrued interest for three months..... | 198,500.00 |
| 3. 2,000 shares of 7% cumulative preferred stock of the Longworth Steel Company at 105, ex-dividend..... | 210,000.00 |

4. 500 shares of 6% preferred stock of the Brownson Trading Company at 96 and accrued dividend for six months due this day.....	49,500.00
5. 3,000 shares of common stock of the Rockway Iron Mining Company at par, payable one-half down and the balance in three months.....	300,000.00
6. 1,000 shares common stock of the Delaware River Power Company in exchange for a similar number of shares of this Company.....	100,000.00
	\$954,250.00

Dividends and interest received for the six-months period ending December 31, 1916, amount to \$27,000; bond interest accrued amounts to \$3,750; and accrued cumulative dividends, to \$1,500. The operating expenses for this period aggregate \$2,800. A dividend of 2% on the company's stock, payable January 15, 1917, is declared by the directors at their meeting on December 31, 1916. All investments are to be carried on the books at the purchase price. The incorporating expenses are to be written off over a period of ten years.

§ 369. Accounting Requirements

The entries to record properly the transactions of this example are simple and need not be set out in full. The procedure and book records required at the time of incorporation have already been fully explained. When stocks of other companies are purchased, it is customary to debit them at the cost price to some suitable account, as "Investments," "Stock Investments," or "Stocks of Other Companies." A like procedure is followed in the purchase of bonds of other companies, substituting the word "Bond" for "Stock." Sometimes both stocks and

bonds are included in one account, but when this is done a special record is kept to show the details of the various securities.

Accrued dividends on stock investments should, if entered at all, be debited to "Accrued Dividends" account; and likewise, accrued interest on bonds, to an "Accrued Bond Interest" account. The income from such investments may be credited to a general "Income" account, or separately to suitable accounts which distinguish between stock dividends and bond interest.

The income and expenditures and the resultant assets and liabilities of this company at the close of the first half-year are reflected in the accompanying income account and balance sheet:

HARLOW MANUFACTURING COMPANY
INCOME ACCOUNT
FOR SIX MONTHS ENDED DECEMBER 31, 1916.

<i>Debits</i>	<i>Credits</i>
July 1, 1916	December 31, 1916
Bond Interest Accrued.. \$3,750.00	Preferred Dividends Received \$8,500.00
Dividends Accrued..... 1,500.00	Preferred Dividends Accrued 1,500.00
Balance (Income for Six Months) 27,000.00	Bond Interest Received. 7,500.00
	Bond Interest Accrued.. 3,750.00
	Dividends 11,000.00
	\$32,250.00
General Expenses..... \$2,800.00	
Incorporating Expenses	Income brought down.. \$27,000.00
Written Off..... 1,000.00	
Net Income for Period. 23,200.00	
	\$27,000.00
	Balance \$23,200.00

BALANCE SHEET, DECEMBER 31, 1916

(End of first six-month period)

<i>Assets</i>		<i>Liabilities</i>	
Cash on Hand.....	\$9,950.00	Capital Stock:	
Investments:		Authorized	\$1,000,000.00
Bonds of Other Com-		Unissued	50,000.00
panies	291,000.00		
Stocks of Other		Outstanding	\$950,000.00
Companies	658,000.00	Dividend No. 1 pay-	
Bond Interest Accrued.	3,750.00	able January 15, 1917	19,000.00
Dividends Accrued....	1,500.00	Undivided Profits....	4,200.00
Incorporation Expenses,			
Balance	9,000.00		
	<u>\$973,200.00</u>		<u>\$973,200.00</u>

§ 370. Operating Company Purchasing Controlling Interest

As was stated above, the holding company is usually created for the sole purpose of buying the stock of a number of existing corporations and thereby to exercise control in their management. This, however, is not always the case.

In the following example the purchasing company is itself actually engaged in operating its plants, but by the purchase of stock it secures control of a company engaged in producing an article needed by it in the manufacture of railway equipment.

The United Equipment Company has purchased \$1,500,000 of the outstanding stock of the Nelson Car Wheel Company at 105, ex-dividend. As payment therefor it is to give \$1,000,000 of its unissued common stock at 125, \$150,000 of its unissued preferred stock at 110, and the balance in cash. The financial statement of the Nelson Car Wheel Company and the balance sheet of the United Equipment Company are as follows:

UNITED EQUIPMENT COMPANY
BALANCE SHEET, JULY 1, 1916

<i>Assets</i>	<i>Liabilities</i>
Property, Plants, and Equipment	Capital Stock—Preferred
\$8,324,500.00	\$4,000,000.00
Inventories of Stock and Material	(Authorized \$5,000,000)
3,240,800.00	Capital Stock—Common
Investments in Stocks and Bonds of Other Companies	7,000,000.00
2,160,000.00	(Authorized \$10,000,000)
Cash on Hand and in Banks	First Mortgage 5% Twenty-Year Bonds, Outstanding
895,940.00	2,500,000.00
Accounts Receivable	(Authorized \$5,000,000)
2,560,300.00	Notes and Bank Loans
Notes and Loans Receivable	1,680,000.00
1,343,400.00	Accounts Payable
Sinking Fund Deposit with Trustee	1,740,300.00
326,900.00	Accrued Interest, Taxes, etc.
Other Assets	172,100.00
857,190.00	Dividends for Half-Year, Unpaid
	420,000.00
	Sundry Reserves
	996,630.00
	Surplus
	1,200,000.00
\$19,709,030.00	\$19,709,030.00

The points of interest in the present illustration are:

1. The entries on the books of the United Equipment Company for the purchase of stock.
2. The entries on the books of the Nelson Car Wheel Company.
3. The consolidated balance sheet of the two companies after the transfer of stock, showing the condition of the United Equipment Company.

The entries required and the consolidated balance sheet of the two companies are shown on the following pages.

§ 371. Entries on Books of Purchasing Company

The only entries on the books of the United Equipment Company are in the accounts relating to capital, cash, investments, and stock premium; the accompanying entries show how the transaction should be handled. The premium of \$75,000 on stock purchased is included in its cost and charged to Investments, thus reflecting as nearly as possible the market value of the stock; it would not be wrong to charge this amount against the Stock Premium account which now shows a credit of \$265,000 taken upon the sale of the company's own stock, leaving a balance of \$190,000.

First Entry

Investments in Subsidiary Companies.....	\$1,575,000	
To Stockholders of Nelson Car Wheel Company		\$1,575,000
For purchase of 15,000 shares, par value \$1,500,000, of the capital stock of the Nelson Car Wheel Company at 105, to be paid for as follows:		
10,000 shares common stock at 125.....	\$1,250,000	
1,500 shares preferred stock at 110.....	165,000	
Cash for the balance.....	160,000	
Total investment.....	\$1,575,000	

Second Entry

Stockholders of Nelson Car Wheel Company	\$1,415,000	
To Capital Stock—Common.....		\$1,000,000
" Capital Stock—Preferred.....		150,000
" Premium on Stock Sale.....		265,000
For issue of stock to the vendors of the Nelson Company stock, as above.		

Third Entry

Stockholders of Nelson Car Wheel Company	\$160,000	
To Cash.....		\$160,000
For settlement of balance on stock purchased of sundry stockholders.		

As a result of the above entries, the cash of the purchasing company is reduced to \$735,940, investments increased to \$3,735,000, outstanding common stock increased to \$8,000,000, outstanding preferred stock increased to \$4,150,000, and stock premium credited for \$265,000. All other items in the balance sheet remain as previously stated. New certificates of stock must now be issued to the selling stockholders of the Nelson Car Wheel Company. Suitable entries must also be made in the official records of the company, comprising the minute book, stock register, and stockholders ledger.

§ 372. Entries on Books of Selling Company

No entries for the sale of its stock are required on the books of account of the Nelson Car Wheel Company. The sale was a personal matter with the stockholders of that company and one in which no official action is required by the board of directors. Any necessary entries must, of course, be made in the transfer book and stock book, and new certificates be issued in exchange for those cancelled.

If for convenience or any other reason the transaction were handled as a company matter, the entries in the general ledger might be as follows:

July 1, 1916

Stock Clearing Account (or United Equipment Company).....	\$1,575,000	
To Sundry Stockholders.....		\$1,575,000
For sale of \$1,500,000 stock of this Company by sundry stockholders to the United Equipment Company at 105.		

Stock of United Equipment Company.....	\$1,415,000	
Cash	160,000	
To Stock Clearing Account (or United Equipment Company).....		\$1,575,000
Stock of the United Equipment Company, and cash received in exchange for \$1,500,000 of stock of this Company, as above, being as follows:		
10,000 shares common stock		
at 125.....	\$1,250,000	
1,500 shares preferred stock		
at 110.....	165,000	
Cash for the balance.....	160,000	
Sundry Stockholders.....	\$1,575,000	
To Stock of United Equipment Co..		\$1,415,000
" Cash		160,000
For stock received as above and cash turned over to the sundry stockhold- ers, as per agreement.		

§ 373. The Consolidated Balance Sheet

The consolidated balance sheet shown herewith contains the assets and liabilities of both companies. This plan of including in one statement the items of a main company and its various subsidiaries is now in general use (Chapter XXXII). It will be seen that the combined balance sheet includes only the two stated companies, while the United Equipment Company's holdings of stock in other companies are shown in the Investments account. It is obvious, however, that this account would not include the stock of companies whose statements are included in the consolidated balance sheet. Even the bond investment of \$250,000 might be deducted from the Investments account and shown separately or even deducted from the outstanding bonds; but for the purpose of illustration it remains in the present consolidated balance sheet.

UNITED EQUIPMENT COMPANY

CONSOLIDATED BALANCE SHEET AS OF JULY 1, 1916

(Including the assets and liabilities of the United Equipment Company and of the Nelson Car Wheel Company)

<i>Assets</i>	<i>Liabilities and Capital</i>
Property, Plant and Equipment.....	Capital Stock:
Stock and Materials on Hand and in Process	Preferred Stock..... \$5,000,000.00
Investments in Stocks and Bonds of Other Companies*	Unissued
Cash on Hand and in Banks.....	850,000.00 \$4,150,000.00
Accounts Receivable.....	Common Stock.....\$10,000,000.00
Notes and Loans Receivable.....	Unissued
Deposit with Sinking Fund Trustees for the Redemption of Bonds.....	2,000,000.00 8,000,000.00
Other Assets.....	Stock of Nelson Car Wheel Company
	\$2,500,000.00
	Stock Unissued.....
	500,000.00
	Total Issued.....
	\$2,000,000.00
	Less Amount Owned by United Equipment Company
	1,500,000.00
	Stock Owned by Others.....
	500,000.00
	Total Stock Outstanding.....
	\$12,650,000.00

First Mortgage 5% bonds of United and Nelson Companies	\$6,000,000.00
Less Bonds Held in Treas- ury for Future Sale....	2,900,000.00
Total Bonds Outstanding.....	3,100,000.00
Notes and Bank Loans.....	2,012,700.00
Accounts Payable.....	1,951,650.00
Accrued Interest, Taxes, and Other Charges	224,200.00
Dividends for Half-Year, Declared and Unpaid	480,000.00
Sundry Reserves.....	996,630.00
Stock Premium.....	\$265,000.00
Less contra.....	75,000.00
Surplus	1,411,350.00
	\$23,016,530.00

*This includes \$250,000 of the outstanding bonds of the Nelson Car Wheel Company.

At The Premium paid for Nelson Company stock.

§ 374. Parent Companies

A useful variant of the holding company is frequently employed to advantage in the exploitation of inventions. A parent corporation in which the patent rights for such inventions are vested, is formed in some selected state where the power to hold the stock of other corporations is legal. Subordinate companies are then formed in the several states to operate in specified territorial districts, and to these companies rights in the inventions are assigned for their respective districts, the parent company usually reserving or acquiring a controlling interest in each subordinate company. The patent rights may be sold outright to the sub-companies, or leased on a royalty basis; or perhaps a mere license may be issued. The subordinate company then operates in its own territory under the general direction of the parent company.

Under this plan the parent corporation makes certain the proper fulfilment of its contracts with the subordinate companies, and also insures the proper harmonizing conduct of general business.* A well-known example is that of the Packard Motor Car Company; its various sales branches throughout the country are separately incorporated companies, of which a majority interest is vested in the parent company. The term "parent" is frequently used, however, for any corporation that owns or controls underlying companies.

Each investment made by the parent company in an underlying company's stock may be charged to "Investments" account, or to a special account carrying the name of the particular stock purchased, as "Stock of Canadian Potato Digger Company." Sales of machines may be made to subordinate companies on liberal terms of credit,

*For a discussion of this subject, see *People v. American Bell Telephone Co.*, 217 N. Y. 241 (1889).

and settlements made at convenient times as collections are made from purchasers. The parent company's income is derived from sales to subordinates, from royalties received from subordinates, and from dividends on its investments in the various companies.

CHAPTER XXXII

CONSOLIDATED BALANCE SHEETS

§ 375. Purposes of Consolidated Balance Sheet

A consolidated balance sheet is one that includes or combines the balance sheets of several different concerns. Many large corporations own or control a number of smaller companies, and, though each may have its own statement, it is frequently necessary or desirable to present all the financial details in one balance sheet, in order to reflect the financial position of the whole group of affiliated companies as one undertaking. The assets and liabilities of the constituent companies are therefore included with those of the controlling company, after eliminating therefrom the intercompany stocks, bonds, and accounts which indicate the relation of one company to another. Such a balance sheet has already been given (§ 373). The general balance sheet of the United States Steel Corporation is an excellent example of a consolidated statement, combining as it does the statements of a number of subsidiary companies.

§ 376. Contents of Consolidated Balance Sheet

The contents of a consolidated balance sheet are practically the same as that of a single company. There are, however, certain points peculiar to such statements which require special attention. They are as follows:

1. Intercompany obligations—existing debts among the constituent companies for goods sold, for advances made to one another, and for bond interest accrued, or declared dividends—being offsetting assets and liabilities, are usually

eliminated from the combined statement, though they are sometimes included, either separately or with other current items.

2. Guarantees, leases, and other contracts existing between the parent company and subsidiaries, are shown in the balance sheet among the assets and liabilities or as footnotes. The frequent exchange of collateral between the parent and subsidiaries, for accommodation purposes, or otherwise, is also a matter of importance.

3. The extent of ownership in the subsidiary companies' stock—whether the parent company owns all, a controlling interest, or only a portion thereof—and the extent of ownership by the underlying companies in the stock of the parent company or of the other companies, should be clearly stated, either in the balance sheet or in a supporting schedule. The minority interest in surplus profits is sometimes indicated also.

4. The parent company's ownership of bonds of the subsidiary companies, and vice versa, should also be shown.

§ 377. Preparation of Consolidated Balance Sheet

The manner of assembling and combining the items of several component companies into a consolidated balance sheet is shown in the following example. Three companies, X, Y, and Z, are used in the illustration, the first being purely a holding company, and the other two, subsidiary operating companies. Intercompany stock holdings and current obligations that require careful handling are included.

Form A, on the following page, shows how the accountant or corporation official gathers details and makes deductions on his "working papers," "working sheets," or "analysis sheets," preparatory to his final exhibit. The assets and liabilities are shown separately and combined.

FORM A
DETAILED BALANCE SHEET
OF HOLDING COMPANY AND TWO OPERATING COMPANIES

DECEMBER 31, 1916

(Showing complete statements of the companies, also analysis of intercompany obligations and stock holdings preparatory to the consolidated balance sheet)

<i>Assets</i>	(1)	(2)	(3)	(4)	(5)	(6)
	Company X	Company Y	Company Z	Combined Eliminations*		Cleared
Plant and Capital Assets.....	\$.....	\$275,000	\$154,800	\$429,800	\$.....	\$429,800
Cash and Sundry Assets.....	150,200	78,800	61,100	290,100	27,000	263,100
Material, Supplies, and Goods in Process.....	.....	311,600	198,400	510,000	.....	510,000
Prepaid and Deferred Charges.....	20,000	38,700	19,200	77,900	.....	77,900
Advances to Subsidiary Companies.....	60,000	.....	.....	60,000	.....	.....
Investments in Company Y, Stock at Par..	175,000	.....	.....	175,000	.....	.....
Investments in Company Z, Stock at Par..	200,000	.....	.....	200,000	.....	.....
Investments in Company X, Stock at Par..	.....	25,000	.....	25,000	.....	.....
Investments in Company Y, Bonds at Par..	30,000	.....	.....	30,000	.....	.....
Totals.....	\$635,200	\$729,100	\$433,500	\$1,797,800	\$517,000	\$1,280,800
<i>Liabilities</i>						
Capital Stock.....	\$500,000	\$300,000	\$200,000	\$1,000,000	\$400,000	\$600,000
Bonds Outstanding.....	.....	50,000	.....	50,000	30,000	20,000
Current Liabilities.....	54,000	265,000	152,100	471,100	.....	471,100
Advances from Company X.....	.....	25,000	35,000	60,000	.....	.....
Owing to Company Z.....	.....	15,000	.....	15,000	15,000	.....
Owing to Company Y.....	.....	.....	12,000	12,000	12,000	.....
Surplus	81,200	74,100	34,400	189,700	.....	189,700
Totals.....	\$635,200	\$729,100	\$433,500	\$1,797,800	\$517,000	\$1,280,800

* If additions are necessary, they may be included in the same column in red ink, or in a separate column.

The eliminations of intercompany items in arriving at the net results are also shown. In the preparation of consolidated balance sheets, the statements of the several companies are prepared separately and then brought together, as shown in this form.

The details shown in the columns of Form A are used as a basis for illustrating different ways of making up consolidated balance sheets, as shown in Forms B and C of the present chapter. In the process of reducing the various units to a common basis, it is necessary to make certain cancellations, as indicated in the fifth and sixth columns of Form A.

§ 378. Consolidated Balance Sheet with Intercompany Details

Form B, which follows, is a very simple example of a consolidated balance sheet, including all of the items of the several companies without any cancellation of intercompany debits and credits. The items are arranged very much as in the fourth column of Form A; in fact, where only two or three companies are concerned the combined information might be presented in a columnar exhibit comprising the first four columns of Form A as they stand.

Among the assets are included \$60,000 of advances to subsidiary companies and \$27,000 of intercompany debts, the latter included with the sundry assets. These are likewise shown as offsetting liabilities. Taking the entire matter as one concern, it will be seen that the company owes \$87,000 to itself. The third form omits these items entirely but refers to them in memoranda or footnotes. Accountants sometimes consolidate only the accounts of the subsidiary companies, the balance sheet of the holding company being presented separately in the ordinary or unconsolidated form.

FORM B
 CONSOLIDATED GENERAL BALANCE SHEET
 OF COMPANY X AND SUBSIDIARIES Y AND Z
 DECEMBER 31, 1916

(Presenting all accounts and intercompany details without cancellations)

Assets

Plant and Capital Assets.....	\$429,800.00
Cash and Sundry Assets.....	290,100.00
Material, Supplies, and Goods in Process.....	510,000.00
Prepaid and Deferred Charges.....	77,900.00
Advances to Subsidiary Companies.....	60,000.00
Investments in Stocks and Bonds of Affiliated Companies*	430,000.00
Total Assets.....	\$1,797,800.00

Liabilities

Capital Stock Outstanding:			
Of Company X.....	\$500,000.00		
Of Company Y.....	300,000.00		
Of Company Z.....	200,000.00	\$1,000,000.00	
Bonds of Company Y.....		50,000.00	
Current Liabilities.....		471,100.00	
Advances and Intercompany Obligations.....		87,000.00	
Combined Surplus		189,700.00	
Total Liabilities.....		\$1,797,800.00	

§ 379. Consolidated Balance Sheet without Intercompany Details

The consolidated balance sheet of Form C, differs from Form B only in so far as intercompany holdings and obligations are concerned, which are indicated in such a way as to make the combined statement clear and easily readable. In reducing the various units to a common basis, the required cancellations are first made as indicated in Form A.

*The investments may be stated separately if desired.

Since the outside or minority stockholders of Company Y own five-twelfths of the capital stock, their interest therein and in the surplus profits is set forth separately. They also have an interest in the surplus of Company X which might be shown. If one-twentieth of Company X's surplus, or \$4,060, belongs to Company Y, then the minority interests of the latter company own five-twelfths of this surplus, or \$1,691.67. A comparison of Forms B and C will show the slight differences in arrangement, indicating as they do that form is not so important as clearness of expression and accuracy of results.

§ 380. Additional Illustrations of Consolidated Balance Sheets

The balance sheet on pages 464, 465, is that of a manufacturing company, and shows an arrangement of details slightly different from those of Forms B and C. It will be noticed that the company's bonds to the value of \$50,000 are included in the assets and also in the liabilities, this amount being owned by a subsidiary. The stock holdings are indicated as a memorandum on each side, while the stock premium is included in the assets, thus indicating that the stock owned is worth more than par. This premium might be charged against surplus. If stock is purchased below par, the discount may be credited to surplus, provided said stock is really worth face value. A deficit of an underlying company should be shown in the consolidated balance sheet as a deduction from surplus.

The division of surplus profits between the holding company and outside interests must obviously depend on the status of the preferred stock. The holders of such stock may or may not have an interest in excess profits over and above the dividend payments; therefore no division is attempted in this exhibit.

Another balance sheet is given on pages 466, 467: that of the Minnesota Lumber Company which owns and operates ten retail yards and four subsidiary companies. In this statement the separate yards and underlying details are contained in supporting schedules. Each schedule assembles and exhibits all of the items of a similar nature on hand at the various yards and companies; Schedules 1 and 4 for cash and merchandise are cases in point. For example, Schedule 1 would show the cash and book balances, or overdrafts, at the various yards and companies as well as at the home office. Schedule 4 would in like manner show the location of all merchandise inventories and supplies of the various yards and companies. Otherwise, the balance sheet differs but slightly from the other forms presented in this chapter. By placing the capital and surplus profits after the liabilities instead of before, it is possible to show the "net worth" of the combined companies.

CONSOLIDATED GENERAL BALANCE SHEET
OF THE VULCAN MACHINE WORKS AND SUBSIDIARY
COMPANIES

As of December 31, 1916

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cost of Property:		First Mortgage Bonds:	
Properties Owned by All Affiliated Companies.....	\$1,650,000.00	6% Bonds of Vulcan Machine Works, Authorized and Issued.....	\$700,000.00
Less Reserve for Depreciation	335,000.00	(Of this amount \$50,000 purchased and held by subsidiary companies, per contra.)	
	\$1,315,000.00		
Investments:		Current Liabilities:	
Bonds of Vulcan Machine Works Held by Subsidiary Companies	\$50,000.00	Accounts Payable.....	\$125,000.00
Stocks of Other Companies		Dividends Declared by Scott Company	3,000.00
Not Controlled by Vulcan Machine Works.....	100,000.00	Bond Interest Accrued.....	12,000.00
Premium Paid on Stocks of Subsidiary Companies (par \$300,000)	15,000.00		
		Intercompany Accounts:	
		(Owing to Affiliated Companies, omitted per contra, \$110,000.)	140,000.00

Available Assets:			Sundry Reserves:	
Inventories	\$234,000.00		For Adjustment of Inven- tories	\$19,200.00
Accounts and Notes Re- ceivable	153,000.00		For Bad Debts.....	2,800.00
Cash in Banks.....	34,000.00	421,000.00		
Intercompany Accounts:			Capital Stock:	
(Obligations of Affiliated Companies, omitted per contra, \$110,000.)			Authorized and Issued:	
			Common	\$300,000.00
			Preferred	300,000.00
Deferred Charges:				
For Affiliated Companies.....		45,000.00	Stock of Subsidiary Companies Owned by Minority Interests.....	200,000.00
Miscellaneous:*			(Stocks of Subsidiary Companies Owned by Vulcan Machine Works, par value \$300,000.)	
Dividends Declared on Stock of Scott Company.....	\$2,700.00			
Accrued Interest on Bonds Held by Subsidiaries.....	500.00	3,200.00	Surplus:†	
			Balance, December 31, 1915	\$246,500.00
			Profits for 1916.....	140,700.00
Good-Will		100,000.00		

*The dividends and the interest may be omitted if desired, being represented on both sides of the balance sheet.
†The share of surplus owned by minority interests depends on the status of the preferred stock.

MINNESOTA LUMBER COMPANY AND SUBSIDIARY COMPANIES

CONSOLIDATED BALANCE SHEET, AS OF JULY 1, 1916

(Comprising the accounts of the Minnesota Lumber Company and its ten retail yards; also of the St. Paul Lumber Company, the St. Cloud Sash & Door Company, and the Minneapolis Saw Mills Company)

<i>Assets</i>		<i>Liabilities and Capital</i>	
<i>Current Assets:*</i>		<i>Current Liabilities:*</i>	
Cash on Hand and in Banks, per Schedule 1.....	\$20,800.00	Overdrafts at Sundry Banks, per Schedule 1.....	\$14,000.00
Accounts Receivable, per Schedule 2.....	375,000.00	Accrued Pay-Roll, Minneapolis Saw Mills Company	15,000.00
Bills and Notes Receivable, per Schedule 3.....	130,000.00	Accounts Payable, per Schedule 2.....	160,000.00
		Bills Payable, per Schedule 3	396,000.00
			\$585,000.00
<i>Inventories, per Schedule 4:</i>		<i>Capital and Surplus:</i>	
Merchandise on Hand at All Yards	\$295,000.00	Capital Stock of the Minnesota Lumber Company and Subsidiaries	\$1,400,000.00
Office Supplies and Prepaid Expense Items.....	13,200.00	Deduct Capital Stock of Subsidiaries, per Schedule 5, Owned by This Company..	500,000.00
Lumber Inventories of Minneapolis Saw Mills Company	150,000.00		
Logs on Hand at Minneapolis Saw Mills Company	90,000.00		
Horses, Cattle, and Hogs at Minneapolis Saw Mills Company	9,000.00	Capital Stock Outstanding..	\$900,000.00
		Surplus Accumulated to Date	275,000.00

Fixed Properties, per Schedule 6:		Net Worth of the Company and Sub-
Equipment of Camps, Yards,		sidiaries
Mills, and Offices.....	\$116,500.00	1,175,000.00
Buildings—Saw and Planing		
Mills, Houses, Offices, etc.	152,000.00	
Real Estate at Various Localities	103,000.00	
Timber Lands of Minneapolis Mills Company.....	100,000.00	
	471,500.00	
Miscellaneous:		
Good-Will	\$200,000.00	
Organization Expenses, balance to be written down (Investment in Stock of Subsidiary Companies, deducted per contra, \$500,000.)	5,500.00	
	205,500.00	
	<u>\$1,760,000.00</u>	<u>\$1,760,000.00</u>

* Intercompany assets and liabilities, comprising advances of \$100,000 to the subsidiary companies, have been omitted since they offset one another. Bank overdrafts amounting to \$24,000 and shown as a liability may with advantage be deducted from the cash, leaving a net cash balance of \$6,800.

AUDITOR'S CERTIFICATE

We have audited the above Balance Sheet, and certify that in our opinion it is properly drawn to show the true financial position of the Minnesota Lumber Company and Subsidiary Companies on July 1, 1916.

F. B. DONALDSON & Co.,
Auditors

Philadelphia, July 15, 1916.

§ 381. Consolidated Income Account

The profit and loss accounts of the parent company and its various subsidiaries may, like the balance sheets, be combined in one comprehensive income statement or profit and loss account. This is a much simpler process, however, than the preparation of a consolidated balance sheet, since it contains no intercompany obligations or stock and bond holdings. It simply groups the similar items, though care must be exercised to see that profits taken on sales of materials and products among subsidiary companies are deducted, especially if these are still on hand and included in the latter's inventories. A columnar working sheet is generally used in combining the various items of income and expenditure, as already illustrated under the balance sheet.

Part VII—Reorganizations, Receiverships, and Dissolutions

CHAPTER XXXIII

REORGANIZATION BY AGREEMENT

§ 382. Definition of Reorganization

“A reorganization of a corporation is a business arrangement (1) whereby the stocks and bonds of the company are rearranged as to amount, income, or priority, or (2) the property is sold to a new corporation for new stock and bonds, or (3) the property is sold by foreclosure of a mortgage upon it, and the purchaser buys for himself and such of the old stockholders and bondholders as he associates with him.”*

§ 383. Methods of Reorganization

According to the definition there are two kinds of reorganization by agreement. The first is a mere readjustment of the rights of the various parties interested, i.e., by the stockholders with the co-operation of the bondholders or other creditors, without forming a new corporation. The problems given in this chapter relate to such readjustments.

The second involves the formation of a new corporation and the voluntary sale of all the property of the old corporation to it in return for its stocks and bonds. The subject of consolidation by merger and by purchase has

*Cook on Corporations, § 883.

been treated in Chapter XXIX, and the accounting problems connected with this method of reorganization are essentially similar.

Both of these methods are called reorganizations by agreement, in contradistinction to reorganizations as the result of legal compulsion where the corporation is insolvent and its property may be sold to pay off the bondholders and creditors.

When the property of a corporation is sold under foreclosure proceedings, the entity of the corporation does not pass. Whatever organization is effected by the purchaser to operate the plant, property, or business taken over, is practically a new organization free from all claim or liability of the old corporation. The accounting problems relating to it are similar to the problems involved in opening the records of a new corporation. These have already been treated in Chapters XI, XII, XIII.

A later chapter will deal with reorganization as the result of a receivership.

§ 384. Reorganization by Reduction of Stock

A reorganization by agreement involving some readjustment of the stock and bonds or both, usually requires the unanimous consent of all the stockholders if it is a stock readjustment, or of all the bondholders if it affects their rights. This would be the case if it were desired to increase or decrease the stock or to issue preferred stock. If the bondholders accept half cash and half a new issue of bonds for their existing securities, it would necessitate a readjustment of this kind.

Such a readjustment could not be enforced against an objecting stockholder or bondholder. In some cases it is possible, however, for those holding the larger interests to buy out the smaller holders who are likely to object, if

they are not too numerous or too unreasonable in their terms.

A reorganization by agreement is a comparatively simple matter. If it involves an increase or reduction of capital stock, most of the states have prescribed procedure and forms for amending corporate charters that are neither costly nor complex. At common law no charter amendment was possible without consent of the legislature and usually of all the stockholders, but under modern procedure most amendments may be made by a majority or by two-thirds or three-fourths of the stockholders. A reduction of capital stock is not as simple as an increase, because in reducing stock, the rights of creditors must be considered, and the surrender of outstanding stock and the issuance of a less number of shares involve some cancellation and re-issue of stock to existing stockholders. Any amendment of the charter is a simple matter in a close corporation with few stockholders. In most of the states any desired amendment may be had by consent, notice and formal procedure being largely waived.

§ 385. Balance Sheet Before Reduction of Capital Stock

As an illustration of the procedure and book records required for reducing the capital stock of a corporation, the following example is given:

The Swift Automobile Company whose statement is given below was formed by the merger of several automobile concerns. At the time of the combination, good-will was placed at \$1,000,000 and surplus at \$340,000. Since then regular dividends of 7% on preferred and 5% on common stock have been paid, excepting the one recently declared and shown among the liabilities. An audit of the books made for the year ending June 30, 1916, showed that obsolete properties, doubtful accounts, and valueless investments to the amount of approximately \$1,000,000 would

have to be written off. The following statement was submitted by the accountants with the recommendation that the good-will be reduced to a conservative valuation:

SWIFT AUTOMOBILE COMPANY AND BRANCHES
BALANCE SHEET, JUNE 30, 1916
(BEFORE REDUCTION OF CAPITAL)

<i>Assets</i>	<i>Liabilities</i>
Cost of Properties and Equipment, including Good-Will \$4,500,000.00	Capital Stock:
Securities Owned, of Subsidiary and Other Companies. 1,300,000.00	Preferred \$1,000,000.00
Sinking Fund Deposit 220,000.00	Common 3,000,000.00
Cash 235,000.00	Total \$4,000,000.00
Accounts Receivable 1,172,300.00	Bonds Outstanding. 2,500,000.00
Bills and Notes Receivable 520,000.00	Short Term Notes. 500,000.00
Material Supplies and Finished Parts 981,600.00	Accounts Payable.. 1,525,000.00
Contract Work in Course of Construction 476,300.00	Notes Payable..... 490,000.00
Accrued and Prepaid Items..... 58,400.00	Accrued Items..... 31,200.00
Total Assets.... \$9,463,600.00	Bond Interest, payable July 1, 1916. 62,500.00
Notes Discounted (per contra).... 850,000.00	Dividend Declared and Unpaid..... 120,000.00
	Sundry Reserves... 189,000.00
	Total \$9,418,600.00
	Indorsement on Notes Discounted (per contra).... 850,000.00
	Balance, Profit and Loss Surplus.... 45,000.00
\$10,313,600.00	\$10,313,600.00

§ 386. Accounting Requirements

Following the suggestion of the accountants, the stockholders in a special meeting called for the purpose, decided

to write off the entire \$1,000,000 of good-will and to add \$500,000 to the surplus by a reduction of the capital stock. The common stock, therefore, is to be reduced to \$1,500,000, while the cumulative preferred stock is to remain as before, and \$500,000 is to be added to the surplus account.

(a) State the procedure required to bring about these changes.

(b) Give the book entries required to adjust the accounts in accordance with the resolutions of the directors and stockholders.

§ 387. (a) Procedure

The reduction of capital stock requires a charter amendment, which must be obtained from the state originally granting the charter and will require the aid of a lawyer. Prescribed procedure must be closely followed.

§ 388. (b) Entries and Records

Complete official minutes of the proceedings, resolutions, etc., must be kept in the minute books of both the directors and stockholders. All certificates of stock must be turned back to the company and interim receipts taken therefor pending the issue of new certificates. Sometimes a trustee is appointed for this purpose in case the company does not already have a regular fiscal agent or registrar upon whom this duty would devolve. The new common stock certificates when issued will be for one-half the number of shares cancelled, so that each holder thereof will own 50% of his former holdings. This does not mean, however, that the company's actual net worth is less than under the former arrangement, nor that the holder of stock has lost anything by the charter amendment. His shares, while formerly valued below par, are now considerably above. The net worth of the company (capital and surplus) is now \$3,045,-

000, so that each of the 15,000 shares of common stock has a book (or intrinsic) value of \$136.33 per share. The book value of the preferred stock remains as before at \$100 per share.

Each stockholder's account in the stock ledger should be debited with the number of shares cancelled, and new certificates of stock reissued for the balance. Another plan is to debit each account for the entire number of former shares in order to close the account, after which the account is credited with the actual number of new shares issued.

The only entry required to be made in the general ledger is one to adjust the Capital Stock, Surplus, and Good-Will accounts, as follows:

July 1, 1916		
Capital Stock—Common.....	\$1,500,000	
To Good-Will (or Plant).....		\$1,000,000
" Surplus		500,000
To record the requirements of a charter amendment granted this day, reducing the number of shares of common stock from 30,000 to 15,000 of the par value of \$1,500,000.		

This entry also cancels the entire Good-Will account and creates an additional surplus of \$500,000.

If it is desired to cancel the old capital stock account and to open a new account for the reduced capital stock, the following plan might be adopted:

Capital Stock—Common.....	\$3,000,000	
To Capital Stock—Common.....		\$1,500,000
" Good-Will		1,000,000
" Surplus		500,000
(Full explanation necessary here.)		

Other methods of stating the journal entry might be used, keeping in mind that accounts should be given such

titles as will readily identify their functions. Referring to the balance sheet, notice the manner of stating the notes under discount at the bank. This plan is used by some accountants. A new balance sheet does not need to be shown at this time since only three accounts are affected by the adjustment. They are:

Common Stock reduced from \$3,000,000 to \$1,500,000.

Good-Will reduced from \$1,000,000 to nothing.

Surplus increased from \$45,000 to \$545,000.

§ 389. Conditions of Reorganization

This company, like many others, has overvalued its properties and has issued its capital stock on the strength of such valuation. The properties and good-will are listed at "cost," that is, after allowing for depreciation; but this only indicates the value placed upon them at the time of purchase, measured in shares of the purchasing company, which evidently was too high. Stock, like water, must find its level sooner or later, and it is well known that the stock market quotations usually show it very close to its intrinsic property valuation after all water or fictitious value has been eliminated.

Assuming that the good-will of \$1,000,000 was largely fictitious, it is apparent that the intrinsic value of the stock was only \$3,000,000, or \$75 per share; if the good-will was represented by common stock, then the market value of the common stock will be reduced by one-third, or to \$66.67 per share, while the preferred stock will remain at or near the par value. By reducing the capital stock to \$2,500,000, the good-will is eliminated and \$500,000 added to the Surplus account, with the result that the actual capital and surplus is then \$3,045,000, and the intrinsic value of all stock averages slightly over \$120 per share. The relative value of preferred and common stock must, of

course, depend upon the status of the preferred; if the latter is entitled to only par value, \$1,000,000 on liquidation, it is obvious that the 15,000 shares of common stock must be worth \$2,045,000 or about \$136 per share, and the preferred slightly above par in harmony with its annual earnings. It will be seen that the stock reduction and elimination of good-will do not enhance the financial stability of the company upon which its credit is based. On the other hand, the status of the preferred and common stockholders remain the same as to proprietorship and participation in profits. The preferred stock will, if business permits, pay its 7% dividend or \$70,000 per year, while the remaining profits will be available for the common stock dividend.

The American Milling Company in 1914 reduced its capital stock from \$3,500,000 to \$700,000, by the elimination of good-will and patents. In a letter sent to the stockholders asking them to vote on the proposed reduction, the following paragraph appeared:

"The good-will and patent rights add nothing to a solid financial basis on which to operate your property and a statement containing items of this character injures us in banking circles to such an extent that your officers are handicapped in making a proper financial showing, and in addition to this we are compelled to pay \$2,800 capital stock tax per annum on this excess which would be saved to you by making the change."

§ 390. Balance Sheet Before Adjustment

To illustrate the reorganization of a company to avoid the appointment of a receiver, the case of the Booth Manufacturing Company may be taken. The stock of this company was in the hands of fifty stockholders, five persons held 60% of it and voted themselves into office from year to year. These five officials paid themselves high salaries and even permitted the capital to become greatly impaired

through extravagance and apparent incompetence. The minority stockholders made application to the court for the appointment of a receiver, on the grounds that they had been treated unfairly and that the interests of the company were being sacrificed for personal advantage of the majority stockholders. The following statement (the case is entirely fictitious) was submitted at the court's request:

BOOTH MANUFACTURING COMPANY
BALANCE SHEET, JUNE 1, 1916
(BEFORE ADJUSTMENT)

<i>Assets</i>		<i>Liabilities</i>	
Real Estate.....	\$20,000.00	Capital Stock (shares	
Machinery and Tools.	12,000.00	\$10 each).....	\$100,000.00
Furniture and Fix-		Mortgage Outstanding	15,000.00
tures	5,000.00	Bank Loans, Indorsed	
Good-Will	25,000.00	by Directors.....	10,000.00
Material and Stock on		Notes Payable.....	25,000.00
Hand	46,800.00	Accounts Payable....	32,700.00
Notes Receivable			
(\$12,000 overdue)*.	27,500.00		
Accounts Receivable			
(\$6,000 doubtful)...	36,200.00		
Cash in Bank.....	5,900.00		
Profit and Loss.....	4,300.00		
	<u>\$182,700.00</u>		<u>\$182,700.00</u>

§ 391. Plan of Adjustment Adopted

In resisting the application for receivership, the directors agreed to a change in the policy and management of the company. This was accepted by the minority interests, thereby obviating the necessity for a receivership. The agreement included the following points:

*\$8,000 of additional customers' notes have been discounted at the bank and bear the Company's indorsement, one of which for \$2,000 made by Thompson Brothers has not been paid and must be taken up by this Company.

1. Cumulative voting is to be authorized so that the minority stockholders will elect two of the five directors.

2. Salaries are to be paid only to persons actually engaged in the company's work and are to be determined by the unanimous vote of all the directors.

3. A campaign of business building is to be inaugurated to make the company prosper as in previous years.

4. No merchandise is to be purchased until the present supply is considerably lessened.

5. Efforts are to be made to enforce prompt payment of notes and accounts receivable.

6. An assessment of 12%, payable forthwith, is to be levied on all stock, in exchange for which certificates of indebtedness, payable in six months without interest, are to be issued.

7. The indorsed bank loans are to be paid off and the personal liability cancelled.

8. Annual audits by certified public accountants are to be made hereafter.

§ 392. Accounting Requirements

In carrying out these requirements and adjustments, the following book entries are required, assuming that \$15,000 of the stock has been disposed of at a profit of \$2,800; that \$6,000 of the overdue notes receivable have been paid and the remainder renewed, and that \$13,500 of accounts receivable have been collected :

June 1, 1916

First Entry

Cash	\$12,000	
To Certificates of Indebtedness.....		\$12,000
For advances made by the stockholders, being a 12% assessment on outstanding stock, and		

represented by certificates of indebtedness payable December 1, without interest, as per special agreement.

Second Entry

Bank Loans.....	\$10,000	
To Cash.....		\$10,000
For payment of indorsed notes at First National Bank, under reorganization agreement.		

Third Entry

Cash	\$17,800	
To Merchandise		\$15,000
" Profit and Loss.....		2,800
For special sale of part of the finished stock at a profit of \$2,800.		

Fourth Entry

Cash	\$19,500	
To Notes Receivable.....		\$6,000
" Accounts Receivable.....		13,500
For payment on account of notes and accounts receivable.		

Fifth Entry

Notes Receivable.....	\$6,000	
To Notes Receivable.....		\$6,000
For renewal of overdue notes by sundry customers.		

Sixth Entry

Thompson Brothers (protested note).....	\$2,000	
To Cash.....		\$2,000
For payment of their dishonored note due today at the bank.		

The revised balance sheet after these entries have been made is as follows:

BOOTH MANUFACTURING COMPANY
BALANCE SHEET, JUNE 1, 1916
(AFTER ADJUSTMENT)

<i>Assets</i>		<i>Liabilities</i>	
Real Estate.....	\$20,000.00	Capital Stock.....	\$100,000.00
Machinery and Tools.	12,000.00	Mortgages Outstand-	
Furniture and Fix-		ing	15,000.00
tures	5,000.00	Certificates of Indebt-	
Good-Will	25,000.00	edness	12,000.00
Material and Stock on		Notes Payable.....	25,000.00
Hand	31,800.00	Accounts Payable....	32,700.00
Notes Receivable....	21,500.00		
Thompson Brothers			
(protested note)....	2,000.00		
Accounts Receivable..	22,700.00		
Cash in Bank.....	43,200.00		
Profit and Loss.....	1,500.00		
	<u>\$184,700.00</u>		<u>\$184,700.00</u>

CHAPTER XXXIV

RECEIVERSHIP

§ 393. Receivers

A receiver is an officer of the court, appointed in an equitable action, to take charge, custody, control, and management of a plant, property, or business, to hold and operate or sell out to the best advantage.

The receiver represents the court, and is subject to its order alone, and any interference with the lawful acts of the receiver is contempt of court. His control is complete, and neither directors, stockholders, nor creditors have any voice in the management while the receiver is in charge.

Of late years the use of receivers in those cases where corporations have become involved in financial difficulties has largely increased. Especially in the case of railroads and the larger industrial corporations, where the enterprise must be continued, has the use of the receiver become the regular course. The law relating to the appointment and procedure of receivers has become extensive and only a few of its more prominent features can be mentioned here.

§ 394. Appointment of Receivers

A receiver may be appointed by a court of equity at the suit of creditors having a lien, a mortgage, or judgment where there is eminent danger of the property being lost, wasted, or misapplied. A receiver may be appointed before foreclosure, in an action to foreclose a mortgage, if necessary to prevent loss, waste, or depreciation.

In extreme cases of fraud and mismanagement on the

part of the officers of the corporation, a court of equity will appoint a receiver at the suit of minority stockholders.

In most of the more advanced states, in addition to the usual powers of the court of equity to appoint receivers, the statutes provide for their appointment in certain specified cases. For example, in New York the statutes provide that a receiver may be appointed in cases of foreclosure of a mortgage when the income has been mortgaged or when a property is insufficient to pay the mortgage debt; also the statutes authorize receiverships in various dissolution proceedings.

Usually a receiver is appointed on the application of a mortgagee or of a trustee of the mortgage deed or trust in connection with the foreclosure proceedings. Where the mortgage covers income, rents, and profits and the corporation is insolvent, the appointment of the receiver is a matter of course. Usually it is to the interest of all concerned that the receiver should be appointed. Where there is any prospect of a reorganization, such an appointment is absolutely necessary.

Usually, in a foreclosure suit the court will not appoint an officer, director, or stockholder of the corporation as receiver, nor any one interested on the other side, unless by agreement of both sides. A trust company may be appointed. The appointment of a receiver rests in the discretion of the court. To handle to the best advantage the affairs of a financially embarrassed corporation requires the highest order of business ability and judgment, and it is not always possible to find such men free when they are needed to take receiverships.

§ 395. Powers of Receivers

From the date of his appointment the receiver takes title to the personal property of the corporation. Real

estate must be conveyed to him by an actual deed unless, as in New York, the statutes provide that real estate as well as personal property passes to the receiver on his appointment. After a receiver is appointed, the officers of the corporation have no more authority to do anything in regard to the corporation business; neither can creditors levy execution, attachment, or other legal process on its property. What is said here applies only to property within the state. If there is property in another state, it will be necessary for the courts of that state to appoint a receiver to take it over.

With the permission of the court appointing him, the receiver may institute suit almost to the same extent as the corporation he represents, but no one can bring suit against the receiver without the permission of the court. He represents the corporation, stockholders, and creditors. In the case of an uncertain or doubtful claim, he may compromise it. He may sell all the assets to a new corporation even where some of the stockholders dissent. This power enables him to promote an effective reorganization.

A receiver cannot undertake new work or extend the operations of the corporation unless he has express authority from the court that appointed him. All that pertains to the usual management and operations of the corporation he may do under his general authority, and the court will sustain him unless his acts are clearly reckless or fraudulent. The books of the corporation are usually placed in his hands and are subject to the inspection of the parties interested.

Any special authority required to preserve the property or to save the rights of creditors or stockholders will be granted by the court on application; for instance, a receiver may be authorized to borrow money to pay pressing claims or to pay interest on coupons due on an underlying mortgage, or to buy new machinery, or to buy rails and rolling

stock. For such purposes the receiver has a right to use the income of the corporation as it comes into his possession, and when this is insufficient he may ask the court for authority to issue receiver's certificates. These are evidences of debt issued by the receiver and take precedence of any existing debts and liens.

The receiver may take over existing leases and contracts or he may decline to continue them. If he continues existing contracts, then sums becoming due on them thereafter, are preferred claims, being part of the receiver's own expenses of operation. Amounts previously due on them and all claims on rejected leases, notes, and contracts have to take their chance with the claims of the general creditors. The receiver's authority to refuse to carry out executory contracts of the corporation is undoubted, and he has a reasonable time to decide as to whether he will adopt or discontinue such contracts.

The receiver will apply the income first to the payment of wages, repairs, and expenses of operation. Until these are paid, the bondholders take nothing.

§ 396. Liability of Receivers

In some cases receivers have managed so badly that on final accounting the expenses of the receivership have consumed the entire property, leaving nothing for the creditors. The discretion of the court was at fault, and in such cases there is no redress. The receiver is not liable for any debts or obligations incurred by him in the discharge of his trust, unless he has been guilty of misconduct. He is not liable for lack of business ability.

If he acts in important matters without express authority from the court, he may make himself liable personally. In a case in Pennsylvania where the receivers were authorized to continue business for six months and they went on for

six months longer, the court held them responsible for the losses of the last six months.

A receiver is allowed reasonable compensation and his counsel fees. In cases where the amount involved is not large, 5% on receipts and also on disbursements is usually allowed. The court will always be governed by the character of the work. The skill shown should be a factor in determining the amount of compensation.

§ 397. Receivers in Bankruptcy Cases

A court of bankruptcy may appoint a receiver to take charge of the bankrupt's property when it is necessary for the preservation of the bankrupt's estate, pending the appointment of the trustee; otherwise the property might be wasted and depreciated. A receiver in bankruptcy has limited powers and his tenure is temporary. It is expected that the trustee will wind up the estate, and hence the receivership is merely a preliminary to his appointment.

The matter of dissolution by bankruptcy is treated in Chapter XXXVII.

§ 398. The Receiver's Accounts

A receiver is required to keep careful record of his transactions and to render frequent accounts during his receivership. To save the time of the court, it is usual to give immediate charge to a master in chancery who has authority to pass on the accounts submitted. His decision is final unless an appeal is taken to the court. Unless the items allowed are unusual, the decisions of the master will be sustained. If the master approves the accounts as rendered from time to time, the court will rarely fail to sustain him.

There being no prescribed form of keeping the receiver's accounts, the accountant may use his own judgment in out-

lining the books to be used or the manner of keeping them. The availability of data pertaining to the trust is the main consideration, however, and should be so regarded in planning the records. No matter what method of account-keeping is used, the receiver is required to state the assets and liabilities of the company at the beginning and termination of his receivership, as well as the various intervening transactions. These statements to the court become public records and are available for general inspection. It may be said that these suggestions apply also to the account-keeping for assignees, trustees, executors, and administrators.

§ 399. The Company's Accounts During Receivership

The general books of an embarrassed company may be adjusted to meet the new condition of affairs, but in most cases they are continued as usual until it is known what is to become of the company. If they are to be kept in harmony with the accounts of the receiver, adjusting entries may be made and all ledger accounts closed, except Capital Stock, Receiver, and Deficiency or Surplus. The debit balance to the receiver's account will stand until the end of the receivership. (For adjusting entries, see § 411.)

Upon termination of the receivership, when the assets and liabilities as then existing are turned back to the company, assuming that business is to be continued, entries must be made debiting assets and crediting the liabilities, the difference being credited to the receiver's account. The receiver's balance (or net worth of the company) will at that time be either greater or less than the amount originally shown, and must then be adjusted into Surplus account. If the capital has undergone certain changes, which is usually the case, suitable adjusting entries must be made to bring it into harmony with present conditions as reflected in the receiver's final official report.

CHAPTER XXXV

RECEIVERSHIP AND REORGANIZATION

§ 400. Preliminaries to a Receivership

When a corporation begins to go behind financially, its officials usually continue to manage it long after the danger point is passed. The creditors or bondholders likewise are loath to take any action likely to precipitate a collapse, and as a result operations usually go on until it is not possible to avoid a public breakdown.

The ordinary small business corporation, under such circumstances, will call a meeting of its creditors, lay a statement of its affairs before them, and the lawyer representing the corporation will ask for an extension of credits, propose a composition, or offer to turn over the business to an assignee or a friendly receiver. The creditors will determine whether it is best to extend credits, accept any proposed composition, or institute insolvency proceedings. Experienced credit men representing larger creditors easily decide what is the best line of policy and, unless matters have gone too far, they generally devise some plan of business reorganization without calling in the aid of the courts.

In the case of larger corporations it is not easy to devise any plan of reorganization without some relief from pressing claims and time to study out practicable methods of reorganization.

The appointment of a receiver attains this end. No suits or claims can be pushed against the corporation, and the business and property are preserved from loss. Nothing else

is so effectual; therefore in all cases where a larger corporation gets into financial difficulties, the first step is to have a receiver appointed. Preliminary to this, those most interested confer together, and decide on a plan of action.

§ 401. Reorganization Agreement

The larger bondholders, when they face default in interest payments and see that a forced sale will not pay what is due, usually get together and prepare an agreement of bondholders or of stockholders, or of both, by which they agree to deposit their holdings, and to sign the agreement to authorize the committee in charge to represent their interests in the outlined plan of reorganization. Those who devise the plan usually appoint a committee on reorganization to take charge of the whole matter. The success of the undertaking depends on the ability and repute of the members of this committee. The appointment of a receiver is but one incident in the plan.

The following is typical of the notices sent out to bondholders or stockholders, or both, when the reorganization of their corporation seems necessary:

TO THE HOLDERS OF
COLLATERAL TRUST FOUR PER CENT GOLD BONDS OF 2002
OF
CHICAGO, ROCK ISLAND & PACIFIC R. R. Co.

The Railroad Company having made default in the payment of the interest due May 1, 1914, on the above bonds, it is imperative that bondholders should immediately unite for the protection of their interests. Bondholders who have not already done so should deposit their bonds at once with the Depositary, CENTRAL TRUST COMPANY OF NEW YORK, at its office, No. 54 Wall Street, or at its branch office, Madison Avenue and 42d Street, New York City, under the agreement dated February 26, 1914. Copies of said agreement may be obtained from the Depositary or from the Secretary of the Committee. Bonds in coupon form must be accompanied by the coupon maturing May 1, 1914. Bonds in registered form and registered coupon bonds must be accompanied by transfers

executed by the registered owner or his attorney duly authorized. Certificates of deposit will be issued by the Depositary for all bonds deposited, and in due course application will be made for listing such certificates of deposit on the New York Stock Exchange.

The protective agreement permits the deposit thereunder of such of the stock of THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY COMPANY as is not pledged under the trust agreement securing the Collateral Trust Bonds, and holders of said stock are requested to deposit the same or to communicate with the Committee.

Any bondholder desiring further information may apply to the members of the Committee or to its secretary.

Dated, New York, May 2, 1914.

JOLINE, LARKIN & RATHBONE,
CRAVATH & HENDERSON,
Counsel

C. E. SIGLER, *Secretary*,
54 Wall Street, New York City.

JAMES BROWN
BERNARD M. BARUCH
HENRY EVANS
FREDERICK STRAUSS
J. N. WALLACE, *Chairman*
Committee

A depositary for the bonds, stock, and other securities is usually named in the agreement of reorganization, or, if not, is appointed by the committee. This depositary is usually some well-known trust company. It is customary to have one depositary for the bonds and another for the stock, and still another for the unsecured claims, if the unsecured creditors joined in the agreement. Some form of certificate of deposit or interim receipt is given to each one who deposits his securities and signs the agreement. Thereafter he has nothing further to do with the matter unless the depositors are called upon to vote in regard to some vital matter concerning the reorganization.

The reorganization committee have full authority and are trustees for the real owners of the securities. As trustees they must act in good faith and may not seek their personal advantage. They cannot make any material alteration of the agreement but must carry it out according to its terms.

Where bonds have been used as security for loans, etc.,

by their owners, the owner is the proper party to assent to the agreement of reorganization, but the new certificates must be issued to the party who holds the bonds as security, unless the debt has been paid off in the meantime. If the new bonds or stock prove valueless, the party who holds them as security may still enforce his original claim against the party who pledged them with him.

The reorganization committee usually appoints a purchasing committee, who bid for the property at the foreclosure sale. They offer in payment certificates of deposit of the various depositaries, showing the amounts of stock and bonds, etc., of the embarrassed corporation that each has deposited, and these are accepted in payment for the property and then cancelled. The property is then turned over to the new company.

§ 402. Conditions Preceding Receivership

The receivership forms and procedure which follow are in accordance with the practice of the Court of Common Pleas of Pennsylvania, and perhaps some change will be necessary for acceptance in the courts of other states. In New York State, for example, the form of account required by the courts differs from the one shown, requiring first a summary of the entire matter, while full particulars are contained in supporting schedules, designated A, B, C, etc. In every case it is, of course, required that the matter shall be set forth logically and clearly.

§ 403. Statement of Affairs

To illustrate receivership records and accounts, let us assume that the Excelsior Machine Company, unable to meet its obligations, was placed in the hands of a receiver on July 1, 1916. A statement of its condition before and after appraisalment is given below.

STATEMENT OF EXCELSIOR MACHINE COMPANY

AT BEGINNING OF RECEIVERSHIP, JULY 1, 1916

<i>Assets</i>	Book Value	Appraised Value
Real Estate, Plant, Good-Will, etc.	\$12,136,500.00	\$11,536,500.00
Investments in Subsidiary and Affiliated Companies (pledged with trustee of collateral trust bonds).....	4,500,000.00	4,000,000.00
Merchandise, Materials, Goods in Process, and Supplies.....	2,178,960.00	2,100,000.00
Deposit with Sinking Fund Trustee:		
Cash	\$350,400.00	
Bonds of This Company... 1,945,800.00	2,296,200.00	2,296,200.00
Accounts Receivable.....	3,245,140.00	3,200,000.00
Notes Receivable*.....	2,862,100.00	2,440,100.00
Cash on Hand and in Banks.....	975,850.00	945,850.00
Total	\$28,194,750.00	\$26,518,650.00

<i>Liabilities</i>	Book Value	Appraised Value
Capital Stock—Preferred 7% Cumulative	\$5,000,000.00	
Capital Stock—Common.....	5,000,000.00	
First Mortgage 5% Bonds, due 1930....	3,500,000.00	\$3,500,000.00
First Mortgage 5% Bonds, due July 1, 1917	3,000,000.00	3,000,000.00
Collateral Trust 5% Bonds, secured by deposit of collateral, per contra.....	4,000,000.00	4,000,000.00
Bank Loans Unsecured.....	500,000.00	500,000.00
Notes Payable.....	1,490,500.00	1,490,500.00
Accounts Payable.....	2,375,640.00	2,375,640.00
Accrued Charges.....	328,250.00	328,250.00
Reserves for Depreciation, Bad Debts, etc.	897,510.00	897,510.00
Liability on Notes under Discount, estimated		60,000.00
Total Liabilities.....	\$26,091,900.00	\$16,151,900.00
Profit and Loss Surplus.....	2,102,850.00	

*Notes under discount at bank, \$400,000 additional.

Balance, Excess of Assets over Liabilities, being Receiver's Equity in the Estate		10,366,750.00
Total	<u>\$28,194,750.00</u>	<u>\$26,518,650.00</u>

NOTE: It might be well to show equities only in the statement of appraisal, deducting all secured liabilities from the assets pledged or mortgaged. Bonds held by the trustee may be deducted from the corresponding liability if desired, and perhaps the trustee's cash also.

§ 404. The Receiver's Activities

Upon his appointment, July 1, 1916, the receiver made an appraisement and statement of the company's affairs and filed his inventory with the court. It revealed the following conditions, all of which are included in the above statement.

1. That the real estate, plant, and good-will should be reduced at least \$600,000, but the depreciation reserve should not be disturbed.
2. That the investments had declined \$500,000 below the book value stated.
3. That the merchandise and material should be reduced to \$2,100,000.
4. That the accounts receivable were estimated to be worth \$3,200,000
5. That notes receivable were doubtful to the extent of \$420,000.
6. That at least \$60,000 of the notes under discount would be dishonored.
7. That \$30,000 for dishonored notes of a customer had been charged to the company's account by the bank.
8. That building extensions now in operation should be continued by the receiver.

The receivership was terminated December 31, 1916, at which time a reorganization took place. The statement of

the receiver at the date of his withdrawal, after a tenure of six months, is shown herewith. It contains the adjustments suggested in his statement to the court, in addition to the following transactions carried out during his incumbency, which were entered in his separate ledger :

1. \$1,200,000 of 6% receiver's certificates were issued, due in four months, dated August 1, and sold at 98.
2. Building extensions were completed at a cost of \$500,000.
3. The factory was kept running at a considerable reduction in capacity.
4. Goods were sold from stock for cash at the best prices obtainable, bringing in \$57,680.
5. Orders were completed and billed, aggregating \$230,000, for which cash was received; the merchandise, etc., on hand being valued at \$2,100,000.
6. \$1,724,440 of the accounts receivable were collected; also \$1,050,880 of the notes receivable, of which \$75,000 applied to notes written off as doubtful.
7. Accrued charges were paid for taxes and labor of \$81,100, and \$196,200 additional for wages of workmen.
8. Material for use in factory amounting to \$72,000 was purchased for cash.
9. Various expenses paid in cash amounted to \$76,500, legal fees \$22,500, and compensation of receiver \$10,000.

§ 405. Accounting Procedure

The accounting procedure to record the receiver's activities in this case require the following records and entries :

1. Receiver's records and entries on taking charge.
2. Receiver's records during his management of the business.
3. Receiver's records and entries upon settlement of the estate.
4. Statement of the receiver's account to the court.
5. Entries to adjust the books of the company upon appointment of the receiver.
6. Entries and adjustments on the books of the company at the time the receiver is discharged.

§ 406. (1) Receiver's Records on Taking Charge

The adjustment of assets as a result of appraisements reduces the surplus of the company to \$366,750, being a shrinkage of \$1,736,100 (§ 411). The net assets of the company now amount to \$10,366,750, as shown by the figures given in the appraisal statement. The receiver opens his own separate ledger and brings into it the assets and liabilities (the latter sometimes omitted), as per appraisalment. In order that notes and accounts receivable written off may not be lost sight of, it is good practice to carry them on the books, say at a value of \$1 each. The receiver's opening entry is as follows:

Opening Entry, July 1, 1916

<i>Assets</i>	
Real Estate, Plant, Good-Will, etc.	\$11,536,500
Investments in Subsidiary and Affiliated Companies, Pledged.....	4,000,000
Merchandise, Materials, Goods in Process, etc.	2,100,000
Deposit with Sinking Fund Trustee.....	2,296,200
Accounts Receivable.....	3,200,000
Notes Receivable.....	2,440,100
Cash on Hand and in Banks.....	945,850

Liabilities

To First Mortgage 5% Bonds, due 1930	\$3,500,000	
“ First Mortgage 5% Bonds, due July 1, 1917.....	3,000,000	
“ Collateral Trust 5% Bonds (secured by deposit of colla- teral, per contra).....	4,000,000	
“ Bank Loans Unsecured.....	500,000	
“ Notes Payable.....	1,490,500	
“ Accounts Payable.....	2,375,640	
“ Accrued Charges.....	328,250	
“ Reserves for Depreciation, Bad Debts, etc.....	897,510	
“ Notes under Discount.....	60,000	
“ Receiver's Equity, Estate of Excelsior Machine Company	10,366,750	
	\$26,518,650	\$26,518,650

To record assets and liabilities of the Excelsior Machine Company, in receivership, taken over this day by decree of the Court. Appraised values used, and all liabilities stated.

In opening the receiver's ledger the various accounts should, of course, be properly classified and located. Space must also be provided for the current business transactions of the receiver. If the liabilities were omitted, as is frequently the case, it is apparent that the receiver's equity account would show a credit of \$26,518,650, the total value of assets; or, if only the property equities were entered, the amount would be \$16,018,650. The sinking fund deposit of \$2,296,200 might be deducted from the outstanding bonded debt in obtaining the property equity, but this would not make any change in the amount of the receiver's equity in the estate.

§ 407. (2) Record of Receiver's Transactions

The receiver must keep a strict record of all business activities in order that he may give a correct account of them to the court. The entries are made in the cash book, though certain of them might properly be contained in the journal. The result of these entries is summarized in the following cash account.

RECEIVER'S CASH ACCOUNT

(Being a record of his transactions from July 1, 1916,
to December 31, 1916)

<i>Receipts</i>		<i>Payments</i>	
Balance, Received from Estate.....	\$945,850.00	Discount on Re- ceiver's Certifi- cates	\$24,000.00
Receiver's Certifi- cates	1,200,000.00	Real Estate Opera- tions	500,000.00
Merchandise	57,680.00	Accrued Charges...	81,100.00
Merchandise	230,000.00	Wages	196,200.00
Accounts Receivable.	724,440.00	Merchandise	72,000.00
Notes Receivable...	975,880.00	Expenses	76,500.00
Notes Receivable (Doubtful)	75,000.00	Legal Expenses....	22,500.00
		Salary of Receiver..	10,000.00
		Receiver's Certifi- cates Paid.....	1,200,000.00
		Interest on Above...	24,000.00
		Total	\$2,206,300.00
		Balance, Cash in Hand	3,002,550.00
	<u>\$5,208,850.00</u>		<u>\$5,208,850.00</u>

§ 408. (3) Receiver's Closing Entries

At the termination of his activities and before the re-organization takes place, the receiver adjusts his ledger accounts to determine the status of the estate. After all entries having to do with merchandise have been posted to

that account, disregarding the conversion of material into finished or partly finished product, it will appear as follows:

MERCHANDISE ACCOUNT

Values Taken Over		Cash Sales.....	\$57,680.00
at Beginning.....	\$2,100,000.00	Cash Sales.....	230,000.00
Purchases	72,000.00	Inventory Valuation	
Profit	265,680.00	at End.....	2,150,000.00
	<u>\$2,437,680.00</u>		<u>\$2,437,680.00</u>

Below are given the various entries to close the receiver's loss and gain accounts, followed by the Profit and Loss account showing a net loss of \$12,520 resulting from the period of receivership supervision.

December 31, 1916

Merchandise, Material, etc.....	\$265,680	
Notes Receivable (Doubtful).....	75,000	
To Profit and Loss.....		\$340,680
To record profit on sales on completion of orders, and collection of doubtful notes.		
Profit and Loss.....	\$353,200	
To Discount on Receiver's Certificates.		\$24,000
" Wages		196,200
" Expenses		76,500
" Legal Expenses.....		22,500
" Receiver's Salary.....		10,000
" Interest on Receiver's Certificates...		24,000
Entries to close all nominal accounts into Profit and Loss.		
Receiver's Equity in Estate.....	\$12,520	
To Profit and Loss.....		\$12,520
To close Profit and Loss into receiver's equity account.		

RECEIVER'S PROFIT AND LOSS ACCOUNT

FOR PERIOD FROM JULY 1, 1916, TO DECEMBER 31, 1916

Discount on Receiver's Certificates	\$24,000.00	Profit on Merchandise Account	\$265,680.00
Wages to Workmen...	196,200.00	Collection of Notes Receivable (Doubt- ful)	75,000.00
Expenses, General....	76,500.00	Receiver's Net Loss...	12,520.00
Legal Expenses.....	22,500.00		
Receiver's Salary.....	10,000.00		
Interest on Receiver's Certificates	24,000.00		
	<u>\$353,200.00</u>		<u>\$353,200.00</u>

The receiver's equity account, showing a balance of \$10,354,230, as per his accompanying statement, should be about as follows:

RECEIVER'S EQUITY ACCOUNT

(Showing equity in estate at beginning and termination)

Net Loss during Receivership	\$12,520.00	Balance of Estate, at Beginning.....	\$10,366,750.00
Balance of Estate, at Termination...	10,354,230.00		
	<u>\$10,366,750.00</u>		<u>\$10,366,750.00</u>
		Balance	\$10,354,230.00

Since a reorganization of the company is to take place under a reorganization committee, the receiver hands over the entire estate as now constituted without making any settlement disbursements. An entry for closing, somewhat similar to the following, is required; giving, of course, the various assets and liabilities in detail:

December 31, 1916

Receiver's Equity Account.....	\$10,354,230	
Sundry Liabilities (itemized).....	16,070,800	
To Sundry Assets (itemized).....		\$26,425,030
To close receiver's accounts on termination of receivership, all assets and liabilities of the estate having been transferred to the Reorganization Committee, per order of the Court, without making distribution of assets.		

The aggregate assets and liabilities are included in the above entry (instead of the equities only as shown in the receiver's final statement), because the assets and liabilities are all spread separately in the book accounts of the receiver.

As a result of all transactions, the receiver's statement at time of closing will appear as follows:

STATEMENT OF RECEIVER OF EXCELSIOR MACHINE COMPANY

AT TERMINATION OF RECEIVERSHIP JURISDICTION, DECEMBER 31, 1916

Assets

Real Estate, Plant, Good-Will, etc.....	\$12,036,500.00	
Less Encumbrance:		
First Mortgage 5%		
Bonds, due 1930.....	\$3,500,000.00	
First Mortgage 5%		
Bonds, due 1917.....	3,000,000.00	6,500,000.00
Receiver's Equity in Property.....	\$5,536,500.00	
Investments in Affiliated Companies	\$4,000,000.00	
Less Deposit to Secure Collateral Trust Bonds.	4,000,000.00	(nil)
Merchandise, Material, Supplies, etc.....	2,150,000.00	
Sinking Fund Deposit with Trustee*....	2,296,200.00	

*This not being available to the receiver might be omitted, in which case the property encumbrance would be reduced by a like amount; the receiver's equity would remain the same in either case.

Interest Accrued on Sinking Fund Deposit	(omitted)
Accounts Receivable.....	1,475,560.00
Notes Receivable.....	1,464,220.00
Cash on Hand and in Bank.....	3,002,550.00
Total Equity in Assets.....	\$15,925,030.00

Liabilities

Bank Loans Unsecured.....	\$500,000.00
Notes Payable.....	1,490,500.00
Accounts Payable.....	2,375,640.00
Accrued Charges, remaining.....	247,150.00
Reserves for Depreciation, etc.....	897,510.00
Liability on Notes Discounted.....	60,000.00
Total Liabilities.....	5,570,800.00
Receiver's Equity, Excess of Assets over Liabilities.....	\$10,354,230.00

§ 409. (4) Receiver's Statement to the Court

The receiver may present to the court only one account or statement, known as the "First and Final Account," or he may present several. An auditor is usually appointed by the court to audit, examine, vouch, and pass upon the receiver's accounts in detail and to report to the court before distributions are made, or dividends paid to creditors. The auditor causes an advertisement to be placed in the papers, giving notice that he will sit on a certain date to receive claims and hear complaints on the audited statement. The hearing may even be adjourned one or more times. The auditor generally makes up a statement of his own from that presented by the receiver, though it is usually briefer and may even be only a summary of the receiver's transactions. It recites in brief, as a rule, the activities of the receiver as an introduction to the audited statement, all of which is later filed with the court, to be kept as a permanent record.

FIRST AND FINAL ACCOUNT OF CHARLES W. BENNETT,
RECEIVER FOR THE EXCELSIOR MACHINE COMPANY

DECEMBER 31, 1916

Debits

The Receiver charges himself as follows.

Inventory and Appraisalment of Assets taken over July 1, 1916:

Equity in Real Estate, Plant, Good-Will, etc.	\$5,036,500.00
Equity in Investments of Subsidiary Companies	(none)
Merchandise, Materials, Goods in Process, and Supplies.....	2,100,000.00
Sinking Fund Deposit with Trustee*.....	2,296,200.00
Accounts Receivable.....	3,200,000.00
Notes Receivable.....	2,440,100.00
Cash on Hand and in Banks.....	945,850.00

Total Assets taken over.....	\$16,018,650.00
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Additions to Capital

For Outlay Increasing Value of Real Es-

tate and Properties.....	\$500,000.00
Increase in Cash, per Cash Account.....	2,056,700.00
Increase in Value of Merchandise.....	50,000.00

Total Increase in Assets.....	2,606,700.00
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Total Value of Assets Taken Over and Acquired.	\$18,625,350.00
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Deductions from Capital

Assets Realized and Collected as Follows:

Accounts Receivable Collected.....	\$1,724,440.00
Notes Receivable Collected.....	975,880.00

Total Deductions.....	2,700,320.00
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Balance, Receiver's Equity in Estate.....	\$15,925,030.00
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The above, it should be noted, omits all liabilities, excepting \$81,100 of previously accrued charges paid off by

*This is not in the hands of the receiver, but if omitted should be added to the equity in properties, increasing the latter to \$7,332,700.

the receiver, and therefore represents equities in all the assets of the estate. If the liabilities were stated, the balance of the estate would be reduced to \$10,354,230, the amount shown in the receiver's equity account (§ 408). The receiver's statement to the court in this case, however, does not take the liabilities into consideration, but does include all activities during his tenure as receiver as shown by the statement of trading and the statement of cash received and disbursed.

The books and records should not be confused with the account rendered to the court.

RECEIVER'S STATEMENT OF TRADING

Expenditures

Inventory Received from Estate at Beginning	\$2,100,000.00	
Purchases of Merchandise.....	72,000.00	
Discount on Receiver's Certificates.....	24,000.00	
Wages to Workmen.....	196,200.00	
Expenses, General.....	76,500.00	
Legal Expense.....	22,500.00	
Receiver's Salary.....	10,000.00	
Interest on Receiver's Certificates.....	24,000.00	
Total Expenditures.....		\$2,525,200.00

Income

Inventory of Assets of Estate, on Hand at Close of Receivership.....	\$2,150,000.00	
Collection of Doubtful Notes.....	75,000.00	
Sales of Merchandise.....	230,000.00	
Sales of Merchandise.....	57,680.00	
Total Income.....		2,512,680.00
Excess of Expenditures over Income, being Net Loss during Receiver's Operations.....		<u>\$12,520.00</u>

STATEMENT OF RECEIPTS AND DISBURSEMENTS
RECEIVER'S CASH ACCOUNT

(Being a record of his transactions from July 1, 1916
to December 31, 1916)

Cash Received

Balance, Received from Estate.....		\$945,850.00
Cash Received from:		
Receiver's Certificates.....	\$1,200,000.00	
Merchandise	230,000.00	
Merchandise	57,680.00	
Accounts Receivable.....	1,724,440.00	
Notes Receivable	975,880.00	
Notes Receivable (Doubtful).....	75,000.00	4,263,000.00
Total		\$5,208,850.00

Cash Paid Out

Discount on Receiver's Certificates.....	\$24,000.00	
Real Estate Operations.....	500,000.00	
Accrued Charges.....	81,100.00	
Wages	196,200.00	
Merchandise	72,000.00	
Expenses	76,500.00	
Legal Expenses.....	22,500.00	
Salary of Receiver.....	10,000.00	
Receiver's Certificates Paid.....	1,200,000.00	
Interest on Above.....	24,000.00	
Total		2,206,300.00
Balance, Cash in Hands of Receiver.....		\$3,002,550.00

Referred to Auditor December 31, 1916.

§ 410. (5) Adjustment of Company's Books on Appointment of Receiver

The books of the embarrassed company are frequently left in the condition that prevailed when the receivership began. In that case no entries of any kind are made until the time of reorganization, when the abandoned accounts

may be adjusted to the new conditions. Sometimes it may be thought advisable, however, to adjust the accounts at both the beginning and end of receivership jurisdiction. This is assumed to have been done with the books of the Excelsior Machine Company.

By referring to the appraisement, it will be seen that numerous adjustments of values were made. The losses sustained thereby should be adjusted into Surplus account in order to bring the ledger into agreement with the property valuations taken over by the receiver.

§ 411. Entries to Adjust Inventories

Shrinkage in assets occasioned by the appraisements are adjusted through the following entry on the books of the company:

July 1, 1916

Surplus	\$1,736,100	
To Real Estate, Plant, etc.....		\$600,000
" Investments		500,000
" Merchandise, etc.....		78,960
" Accounts Receivable.....		45,140
" Notes Receivable.....		422,000
" Cash		30,000
" Notes under Discount.....		60,000
To adjust losses and shrinkage in as- sets, per appraisement of receiver.		

It will be seen that this adjustment reduces the surplus of the company from \$2,102,850 (§ 406) to \$366,750.

Closing entries should then be made, charging the receiver with the assets and liabilities taken over, as follows:

July 1, 1916

Receiver	\$26,518,650	
To Real Estate, Plant, Good-Will, etc.		\$11,536,500

To Investments in Subsidiary and Affiliated Companies, Pledged	4,000,000
“ Merchandise, Materials, Goods in Process, etc.....	2,100,000
“ Deposit with Sinking Fund Trustee	2,296,200
“ Accounts Receivable.....	3,200,000
“ Notes Receivable.....	2,440,100
“ Cash on Hand and in Banks..	945,850
To record transfer of Company's assets to the receiver, as per order of the Court.	

First Mortgage 5% Bonds, due 1930.....	\$3,500,000	
First Mortgage 5% Bonds, due July 1, 1917	3,000,000	
Collateral Trust 5% Bonds (secured, per contra)	4,000,000	
Bank Loans, Unsecured.....	500,000	
Notes Payable.....	1,490,500	
Accounts Payable.....	2,375,640	
Accrued Charges.....	328,250	
Reserves for Depreciation, Bad Debts, etc.	897,510	
Notes under Discount.....	60,000	
To Receiver.....		\$16,151,900
For liabilities taken over by the re- ceiver this day, by order of the Court.		

The receiver's account in the company's ledger now shows a debit balance of \$10,366,750, corresponding with the estate equity account of the receiver in his own ledger. The company's accounts after transferring the assets and liabilities to the receiver appear as follows:

TRIAL BALANCE, JULY 1, 1916

Receiver's Account.....	\$10,366,750.00	
Capital Stock—Preferred.....		\$5,000,000.00
Capital Stock—Common.....		5,000,000.00
Surplus		366,750.00
	<u>\$10,366,750.00</u>	<u>\$10,366,750.00</u>

§ 412. (6) Entries on Termination of Receivership

It is not ordinarily advisable for the company to take the assets and liabilities back into its ledger accounts until the reorganization takes place. At that time the various adjustments should, of course, be made in order to reopen the ledger in harmony with the reorganized conditions. If it is thought desirable, however, to take the assets and liabilities as shown by the receiver's final statement into the company's ledger accounts, with the idea of making reorganization adjustments later, the entry would be:

Closing Entry, December 31, 1916

Debits

Real Estate, Plant, and Good-Will.....	\$12,036,500
Investments	4,000,000
Merchandise, Materials, etc.....	2,150,000
Sinking Fund Trustee.....	2,296,200
Accounts Receivable.....	1,475,560
Notes Receivable.....	1,464,220
Cash	3,002,550

Credits

To First Mortgage 5% Bonds, due 1930	\$3,500,000
“ First Mortgage 5% Bonds, due July 1, 1917.....	3,000,000
“ Collateral Trust Bonds.....	4,000,000
“ Bank Loans.....	500,000
“ Notes Payable.....	1,490,500
“ Accounts Payable.....	2,375,640
“ Accrued Charges.....	247,150
“ Reserve for Depreciation, etc..	897,510
“ Liability on Notes under Discount	60,000
“ Receiver's Account.....	10,354,230
To record existing assets and liabilities on books of the company on termination of receivership (preceding the reorganization adjustments).	

It will be seen that there is a difference of \$12,520 in the receiver's account, which amount must now be adjusted into surplus by the following entry:

Surplus	\$12,520	
To Receiver.....		\$12,520
To close and adjust receiver's account into Surplus.		

The Surplus account now shows a credit balance of \$354,230, thus indicating a heavy shrinkage as a result of the receivership and its resulting destruction of values. After the reorganization takes place, these ledger accounts will, of course, be readjusted to harmonize with the new conditions as adopted by the committee of reorganization.

In the case of railways and public utilities, there is good reason for keeping the company's books continuously during the receivership regardless of the receiver's records, since it is usually a foregone conclusion that, because of their necessary service to the community, they will continue operations as usual, both during and subsequent to the receivership jurisdiction.

CHAPTER XXXVI

RECEIVERSHIP AND SALE

§ 413. Introductory

Reorganization following the appointment of a receiver, and the necessary accounting procedure have been set forth in the preceding chapter. If, as it may happen, a reorganization cannot be effected, it becomes the duty of the receiver to sell the property and use the proceeds of the sale in paying (1) the expenses of the receivership and sale, (2) the creditors or bondholders of the corporation. If anything remained the corporation would be entitled to it. In the case that follows the receiver was able to sell the property so as to give the old stockholders a liberal cash payment and stock in the new corporation. This is an unusually good showing. The payment to the stockholders would involve the dissolution of the old corporation; otherwise the distribution would be illegal.

§ 414. Statement of Condition

The following statements are informal and only intended to illustrate the principles involved. A more formal presentation of a receiver's accounts will be found in the next chapter.

The Willis Grocery Company was placed in the hands of a receiver on April 1, 1916, at the request of merchandise creditors. William Hart was appointed receiver with full authority to continue the business under court supervision and to conserve the company's property, in the hope of effecting a favorable settlement with the creditors. Following is the statement before making appraisalment:

STATEMENT OF THE WILLIS GROCERY COMPANY

AS OF APRIL 1, 1916

(Showing condition upon appointment of receiver, William Hart, before making appraisements and book adjustments.)

<i>Assets</i>		<i>Liabilities</i>	
Buildings, Properties, and Warehouses....	\$50,000.00	Capital Stock.....	\$200,000.00
Store Equipment.....	10,000.00	Less Uncalled Sub- scriptions	50,000.00
Delivery Equipment..	10,000.00		
Merchandise in Stock	75,600.00	Outstanding	\$150,000.00
Produce on Hand....	11,850.00	Mortgage on Real Es- tate	25,000.00
Accounts Receivable..	85,410.00	Bank Loans Secured by Deposit of In- vestments (per con- tra)	10,000.00
Notes Receivable....	12,500.00	Notes Payable.....	15,000.00
Investments in Bonds of Unlisted Com- panies	25,000.00	Accounts Payable....	91,460.00
Cash on Hand.....	5,820.00		
Impairment of Capital	5,280.00		
	<u>\$291,460.00</u>		<u>\$291,460.00</u>

Experts appointed by the court to appraise the assets made the following reductions, based partly on going values:

Value of Merchandise reduced by.....	\$10,000.00
Value of Produce reduced by.....	2,000.00
Accounts Receivable written off as worthless.....	4,270.00
Notes Receivable written off.....	1,800.00
Depreciation of Properties and Buildings written off.....	6,200.00
Depreciation of Store Equipment.....	2,000.00
Depreciation of Delivery Equipment.....	2,000.00
Value of Investments reduced by.....	3,000.00
	<u>Total reductions.....</u>
	<u>\$31,270.00</u>

The receiver, after complying with all legal requirements, continued the business for five months in an effort to put the company on its feet, but without success. Pro-

posals for reorganization were not acceptable to the unsecured creditors or to the stockholders. On September 1, 1916, a meeting of stockholders and creditors was called, and a proposition to sell the business as a going concern to a new corporation was accepted. The terms of sale were as follows:

1. Payment through the receiver to the former stockholders as follows:
 - (a) \$60,000 in stock of the new company.
 - (b) \$50,000 in cash, to be turned over out of the assets.
2. New company to take over all remaining assets and assume all liabilities, continuing the former set of books.
3. All expenses of sale to be met by the purchasers.

The transactions of the receiver up to September 1 are shown below:

RESULTS OF OPERATIONS BY THE RECEIVER

FROM APRIL 1 TO SEPTEMBER 1, 1916

Receipts

Collections from Notes Receivable.....	\$5,500.00
Collections from Accounts Receivable.....	22,640.00
Sales of Merchandise.....	53,750.00
Sales of Produce.....	24,800.00

Expenditures

Purchases of Merchandise.....	\$9,620.00
Purchases of Produce.....	13,110.00
Payment of Wages.....	4,000.00
Operating Expenses.....	4,500.00
Expenses and Salary (Nominal) of Receiver.....	1,500.00
Interest Accrued on Mortgage, September 1, 1916, Unpaid...	625.00

The accounting procedure which follows illustrates on the books of the dissolving company:

1. The receiver's records and entries upon taking charge.
2. The receiver's entries for his official business transactions.
3. The balance sheet of the company on September 1, 1916, as presented by the receiver to the meeting of stockholders and creditors.
4. The receiver's entries upon dissolution of the company and sale of its assets and liabilities.

§ 415. (1) Receiver's Records on Taking Charge

The receiver's statement upon appointment shows a deficit of \$36,550 after allowing for depreciation and deductions. The statement is similar to the one shown in § 414, but with asset values reduced and the Capital Stock account usually omitted. The appraisal statement is presented to the court for record.

The receiver continues the same books of account after making the required adjustments, so that only adjusted balances of accounts appear in the ledger. Under these conditions his official transactions are entered up as in any ordinary business. The adjusting entries to harmonize the accounts with the revised statement of condition are given below. The plan followed in this instance might not apply in every case or be acceptable to all accountants, yet it is simple and can be readily understood. The inventories of merchandise and produce have been entered to the accounts without journal entries.

First Entry

April 1, 1916

Profit and Loss.....	\$31,270	
To Merchandise		\$10,000
" Produce		2,000
" Accounts Receivable.....		4,270

To Notes Receivable.....	1,800
" Buildings and Properties.....	6,200
" Store Equipment.....	2,000
" Delivery Equipment.....	2,000
" Investments	3,000

To record the loss on notes and accounts receivable and reduction in values of stock, properties, and equipment—to harmonize the accounts with the receiver's statement of affairs.

The ledger now shows an impairment or debit to Profit and Loss of \$36,550, and with an outstanding capital of \$150,000, this leaves an equity of only \$113,450. These two accounts should not appear in the receiver's ledger at all, and therefore are closed out by journal entry, leaving instead a credit balance of \$113,450 to "Willis Grocery Company Estate" account. The required journal entry would be as follows:

April 1, 1916

Second Entry

Capital Stock.....	\$150,000	
To Profit and Loss.....		\$36,550
" Willis Grocery Company Estate.....		113,450
To close the Capital Stock and Profit and Loss accounts and to open Willis Grocery Estate account to show the receiver's equity therein.		

§ 416. (2) Entries to Record Receiver's Activities

The recording of the receiver's activities would be made in the cash book and journal. The cash book entries are summarized in the cash account given below and the closing journal entries follow:

RECEIVER'S CASH ACCOUNT

APRIL 1 TO SEPTEMBER 1, 1916

<i>Receipts</i>		<i>Disbursements</i>	
Balance taken over		Merchandise Purchases	\$9,620.00
April 1, 1916.....	\$5,820.00	Produce Purchases....	13,110.00
Notes Receivable.....	5,500.00	Payment of Wages....	4,000.00
Accounts Receivable..	22,640.00	Operating Expenses...	4,500.00
Sales of Merchandise..	53,750.00	Expenses and Salary	
Sales of Produce.....	24,800.00	of Receiver.....	1,500.00
		Total	\$32,730.00
		Balance in Hands of	
		Receiver	79,780.00
Total	<u>\$112,510.00</u>		<u>\$112,510.00</u>

September 1, 1916

First Entry

Produce	\$4,340	
Merchandise	530	
To Profit and Loss.....		\$4,870
For profit on sale of produce and merchandise.		

Second Entry

Profit and Loss	\$10,625	
To Wages		\$4,000
" Expenses		4,500
" Receivership Expenses.....		1,500
" Accrued Interest.....		625
To close above accounts into Profit and Loss,		
and to enter up accrued interest.		

Third Entry

Surplus and Deficiency.....	\$5,755	
To Profit and Loss.....		\$5,755
To close Profit and Loss account into Surplus		
and Deficiency account.		

The foregoing entries when posted result in the following balance sheet as of September 1, 1916.

In case a Surplus and Deficiency account is not kept, the balance should be closed into the estate account.

§ 417. (3) Receiver's Statement of Condition

RECEIVER'S STATEMENT OF CONDITION OF WILLIS GROCERY COMPANY

(As submitted to the meeting of stockholders and creditors at date of sale, September 1, 1916.)

<i>Assets</i>		<i>Liabilities</i>	
Buildings and Prop- erties	\$43,800.00	Secured Bank Loans.	\$10,000.00
Less Mortgage Out- standing	25,000.00	Notes Payable.....	15,000.00
		Accounts Payable....	91,460.00
		Interest Accrued.....	625.00
Equity in Property.	\$18,800.00	Total	\$117,085.00
Store Equipment....	8,000.00	Balance of Estate, be- ing excess of Assets	
Delivery Equipment..	8,000.00	over Liabilities.....	107,695.00
Investments (\$12,000 pledged)	22,000.00		
Merchandise	22,000.00		
Produce	2,500.00		
Notes Receivable....	5,200.00		
Accounts Receivable.	58,500.00		
Cash on Hand.....	79,780.00		
Total	\$224,780.00	Total	\$224,780.00

It is apparent from the above statement that the estate's deficit is \$42,305 after allowing for \$150,000 of outstanding capital. In other words, the stockholders have \$107,695 of their capital left.

§ 418. (4) Entries for Sale and Dissolution

The price secured for the business is slightly more (\$2,305) than the net value of the estate as shown by the receiver's statement of condition. As a going concern, how-

ever, there is a good-will element which has not been stated in the balance sheet.

In this illustration all the accounts in liquidation are cleared through a receiver's realization and liquidation account as shown below. A further use of this account is shown in Chapter XXXVII, "Dissolution of Corporations."

All transfers of properties must be made by the receiver and properly recorded in the county records. After transfer of the business to the purchasers, the balance remaining would belong to the stockholders. In this case the stockholders did not desire to continue a losing business with impaired capital; they therefore dissolved the corporation and directed the receiver to distribute the remaining assets to the stockholders. The court made its order to the same effect, and, after compliance and the rendition of his final accounting to the court, the receiver was discharged.

First Entry (For transfer of assets to the purchasers)

September 1, 1916

Realization and Liquidation Account.....	\$199,780	
To Sundry Assets (itemized).....		\$199,780
For sale and transfer of assets, as per receiver's statement, to purchasers of the business; by resolution of the stockholders and court order. (Mortgage is entered among the liabilities.)		

Cash to the amount of \$50,000 is held back by the receiver as per agreement. At the proper time he hands this over to the parties in interest.

Second Entry (Transfer of liabilities to purchasers)

Sundry Liabilities (itemized).....	\$142,085	
To Realization and Liquidation Account		\$142,085
For transfer of all liabilities (including mortgage) to the purchasers, by court order.		

Third Entry (Receipt of stock from purchasers)

Stock of New Company.....	\$60,000	
To Realization and Liquidation Account		\$60,000
Being part of sale price agreed upon for the business as a going concern, the cash and stock to be turned over to the stockholders by the receiver.		

Fourth Entry (To adjust profit on sale of business)

Realization and Liquidation Account.....	\$2,305	
To Surplus and Deficiency.....		\$2,305
To record profit realized on sale of business, this amount being in excess of the net worth.		

Fifth Entry (Adjustment of capital and surplus accounts and distribution of proceeds)

Capital Stock.....	\$150,000	
To Cash		\$50,000
" Stock of New Company.....		60,000
" Surplus and Deficiency.....		40,000
For distribution of cash and stock among the stockholders in proportion to their holdings, each receiving eleven-fifteenths in value of his former holdings; and for closing capital and surplus accounts.		

All book accounts of the dissolving company are now closed out, the company's charter is surrendered by due process, and the receiver discharged.

CHAPTER XXXVII

DISSOLUTION OF CORPORATIONS

§ 419. Voluntary Dissolution

In most of the states a corporation may be dissolved by its stockholders, the procedure being simple; and while in some states unanimous consent is required, in others two-thirds, three-fourths, or even a bare majority is enough to terminate the corporate existence.

Many of the smaller corporations end their existence informally by failure to pay taxes or to make corporate reports, in consequence of which the state forfeits the charter under which they operate.

In case of voluntary dissolution, the directors are the trustees authorized to settle the company's affairs, and they may bring this about in the simplest manner possible. The chief difficulty, however, lies in collecting outstanding accounts, and in disposing of properties without too great sacrifice. The liquidation of liabilities may begin at once, or as rapidly as cash is received. As the assets are sold, entries are made through the cash account; a like procedure being required also for cash disbursements. Losses may be closed into some clearing account as "Profit and Loss," "Deficiency," or "Surplus"; and this in turn, as a final step, is closed into the Capital Stock account. There is nothing peculiar about closing the books of a corporation when it is dissolved, and any accountant or bookkeeper can handle the situation without trouble.

§ 420. Dissolution Through Bankruptcy

The insolvency or bankruptcy of a corporation does not

necessarily involve dissolution. Unless formal proceedings are taken to dissolve the corporation, it will survive and may be again used as a business organization. As there is a possibility of the officers and stockholders being involved in penalties and liabilities, it is safer to go through a formal dissolution.

When a corporation becomes insolvent, its affairs are usually wound up by bankruptcy proceedings. As soon as the trustee in bankruptcy is appointed, he is required to make an inventory and appraisal of the estate, showing the exact condition of the insolvent corporation. This is known as a "Statement of Affairs," and is made in the simplest way possible for the convenience of both court and creditors. With the statement of affairs is frequently presented a "Deficiency Account," showing the company's capital impairment and how such impairment or deficit of capital came about.

A statement of affairs is somewhat similar to a balance sheet. It is prepared from the books, schedules, creditors' claims, etc., and contains on one side all liabilities, distinguishing between those which are unsecured, partially secured, or fully secured; the preferred claims are set forth on the same side of the statement. On the other side, the assets of the concern are shown at their nominal or book value, and also at the value which they are expected to realize. Any assets which have been given or pledged as security for creditors' claims are separated from those which are available for distribution among the unsecured creditors. The difference between the two sides of the statement shows either the nominal net surplus or net deficiency, and is transferred to a special account known as the "Deficiency" account. Contingent liabilities should also be shown among the liabilities and the loss expected thereon should be indicated.

§ 421. The Deficiency Account

The deficiency account shows on one side the net deficiency as transferred from the statement of affairs, the capital accounts, and the profits made on the business since its commencement or since a date when the books show it to have been in a sound condition. On the other side are shown the losses incurred in realizing upon the assets, any withdrawal of profits, and losses not otherwise provided for in the statement.

The object of the deficiency account is to show the amount of any deficit and its various items. It shows to what extent the capital has been impaired or how far the company falls short of being solvent. It is practically a Profit and Loss account, but is opened only in case of insolvency proceedings. The deficiency account and the items with which it is debited and credited are as follows:

DEFICIENCY ACCOUNT

Debit:

With dividends paid.
 With losses through failures as per Profit and Loss account.
 With shrinkage in assets as per statement of affairs.
 With depreciation of accounts receivable.
 With depreciation of merchandise.
 With depreciation of fixtures, etc.

Credit:

With capital investment.
 With surplus profits at closing of previous period.
 With profit on trading.
 With balance, deficiency per statement of affairs.

§ 422. Realization and Liquidation Account

The realization and liquidation account is a summary of the assets to be realized and the liabilities to be liquidated, with the accompanying entries for assets actually realized

and for liabilities liquidated. This account, or statement, can be readily understood by reference to the accompanying illustration.

REALIZATION AND LIQUIDATION ACCOUNT

<i>Debit:</i>	<i>Credit:</i>
With assets to be realized.	With liabilities to be liquidated.
With liabilities liquidated.	With proceeds of assets realized.
With expenses of realization and liquidation.	With loss due to liquidation, charged to Capital account.
With supplementary charges if any.	With supplementary credits if any.

This account is similar to that of the receiver or trustee to whom is given the duty of settling the company's affairs. He is charged with all the assets of the company turned over to him, and credited with all the liabilities assumed. He is then in turn credited for all cash received from realization of assets, cash being debited; and he is debited for all liabilities discharged, since they cease to be offsets to the assets taken in trust, cash at the same time being credited. It will be seen that the trustee's cash account becomes a supplement to the realization and liquidation account.

§ 423. Statement of Condition

The Longworth Store Company being unable to meet its obligations, is forced into bankruptcy by the creditors. From the books, from the schedules of the company's affairs, from creditors' proved claims, and from the appraisements, the following statement of condition has been ascertained as of May 1, 1916, by the trustee in bankruptcy:

Cash on Hand.....	\$5,500.00
Customers' Accounts, \$1,000 good; \$600 doubtful, but estimated to produce \$200; \$1,000 bad.....	2,600.00
Property, estimated to produce \$9,000.....	14,000.00
Notes Receivable, good.....	4,250.00
Securities, \$3,000 pledged with partially secured creditors; remainder held by fully secured creditors.....	28,000.00
Merchandise, expected to bring \$15,000.....	24,650.00
Dividends paid during year, 25%.....	6,250.00
Trade Losses, due to drop in price of goods.....	7,400.00
Creditors Unsecured.....	25,000.00
Preferred Claims—Wages, Salaries, and Taxes.....	700.00
Creditors Partially Secured.....	23,900.00
Creditors Fully Secured.....	17,000.00
Capital Stock.....	25,000.00
Surplus	1,050.00

In the course of the bankruptcy proceedings the following accounting exhibits are required:

1. A statement of affairs, showing the assets and the liabilities with respect to their realization and liquidation.
2. A deficiency account, showing such of the above stated particulars as would account for the deficiency exhibited in the statement of affairs.
3. A realization and liquidation account, showing settlement of the estate.

§ 424. (1) Statement of Affairs

The trustee, or his accountant, prepares the statement of affairs from information gleaned from the various sources open to him, and submits it, together with the complementary deficiency account, to the meeting of creditors. He submits also his inventory and appraisalment to the court for record in the court journal. It is apparent that the trustee should either be an accountant himself, or should engage the services of an accountant for the determination

of the company's condition and for compiling the many various details that will be found necessary in preparing his statements.

A trial balance is compiled as a preliminary to the preparation of a statement. The statement of affairs and the deficiency account which follow illustrate the manner of setting forth the information called for. The trustee's cash account is a simple statement of receipts and payments. All payments are to be supported by vouchers which, with all other records, are presented for the official audit at the proper time. Careful minutes are kept of all meetings of creditors, resolutions, court orders, etc., in order that a full report as to the existing conditions may be prepared whenever required.

The directors of a corporation are not usually liable for the debts of the company, but in the case illustrated an interim dividend has apparently been paid out of capital and, if this should be so, the amount must be made good by the directors.

TRIAL BALANCE, MAY 1, 1916.

Cash	\$5,500.00	
Customers	2,600.00	
Property	14,000.00	
Notes Receivable.....	4,250.00	
Securities	28,000.00	
Merchandise	24,650.00	
Dividends	6,250.00	
Trade Losses.....	7,400.00	
Creditors Unsecured.....		\$25,000.00
Creditors Partially Secured.....		23,900.00
Creditors Fully Secured.....		17,000.00
Wages, Salaries, Taxes.....		700.00
Capital Stock.....		25,000.00
Surplus from Previous Year.....		1,050.00
	<u>\$92,650.00</u>	<u>\$92,650.00</u>

LONGWORTH STORE COMPANY

STATEMENT OF AFFAIRS

AT DATE OF FAILURE, MAY 1, 1916

<i>Assets</i>	Book Value	Estimated to Realize
Cash on Hand.....	\$5,500.00	\$5,500.00
Property	14,000.00	9,000.00
Notes Receivable, good....	4,250.00	4,250.00
Customers:		
Good	1,000.00	1,000.00
Doubtful	600.00	200.00
Bad	1,000.00	
Merchandise	24,650.00	15,000.00
Securities \$28,000.00	28,000.00	
Pledged with Partially Secured Cred- itors, per contra.....	3,000.00	
	\$25,000.00	
Pledged with Fully Secured Creditors for Debts of \$17,000.....	25,000.00	
Surplus of Securities, per contra.....		8,000.00
Total	\$79,000.00	\$42,950.00
Deduct Preferred Creditors, per contra.....		700.00
Assets Available for Dividends.....		\$42,250.00
(Equivalent to a dividend of 92.07% on claims of 45,900, exclusive of realization expenses.)		
Balance, Deficiency per Deficiency account.....		3,650.00
		<u>\$45,900.00</u>

<i>Liabilities</i>	Gross Amount	Expected to Rank
Unsecured Creditors:		
On Book Accounts.....	\$25,000.00	\$25,000.00

Fully Secured Creditors:

On Book Accounts.....	\$17,000.00	17,000.00
Estimated Value of Securities.....	25,000.00	

Surplus, to contra.....	\$8,000.00	
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Partially Secured Creditors:

On Book Accounts.....	\$23,900.00	23,900.00
Estimated Value of Securities.....	3,000.00	20,900.00

Preferred Creditors:

Wages, Salaries, Taxes, deducted from assets per contra.....	700.00
---	--------

Total	\$66,600.00
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Liabilities Due to Ranking Creditors.....	\$45,900.00
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§ 425. (2) Deficiency Account

LONGWORTH STORE COMPANY

DEFICIENCY ACCOUNT

AT TIME OF FAILURE, MAY 1, 1916

(Being an analysis of the deficiency as shown in the statement of affairs.)

<i>Debits</i>		<i>Credits</i>	
Loss from Shrinkage		Capital Stock Invested	\$25,000.00
in Assets:		Surplus Profits from	
Property	\$5,000.00	Previous Year.....	1,050.00
Merchandise	9,650.00		
Customers' Accounts	1,400.00	Total Credit.....	\$26,050.00
		Balance, Deficiency, per	
Total Shrinkage...	\$16,050.00	Statement of Affairs	3,650.00
Interim Dividends Paid	6,250.00		
Trade Losses.....	7,400.00		
	<u>\$29,700.00</u>		<u>\$29,700.00</u>

NOTE: It will be seen that the capital and surplus, amounting to \$26,050, have been wiped out, and \$3,650 of the assets besides.

§ 426. Trustee's Cash Account

The activities of the trustee in realizing upon assets and in liquidating liabilities are set forth in the following cash account. Several months are usually required for the settlement of an estate in bankruptcy, and during that period two or more dividends may be paid to creditors.

FIRST AND FINAL ACCOUNT OF
ALFRED S. DICKINSON, TRUSTEE IN BANKRUPTCY
FOR THE ESTATE OF LONGWORTH STORE COMPANY,
BANKRUPT
DECEMBER 1, 1916

The Trustee Charges Himself with

Cash Taken Over.....	\$5,500.00
Proceeds of Sale of Property.....	9,000.00*
Profit on Sale of Property.....	1,000.00
Proceeds of Sale of Merchandise.....	15,000.00*
Profit on Sale of Merchandise.....	1,000.00
Amounts Collected from Notes Receivable.....	4,250.00
Amounts Collected from Customers.....	1,200.00
Amounts Collected from Customers in Excess of Estimate	50.00
Proceeds of Sale of Pledged Securities (less claims of Secured Creditors, \$20,000, per contra).....	28,000.00
Total Debits.....	<u>\$65,000.00</u>

The Trustee Takes Credit for

Payment of Preferred Claims.....	\$700.00
First Dividend to Unsecured Creditors, being 50% on \$45,900	22,950.00
Payment to Fully Secured Creditors from Sale of Pledged Securities, per contra.....	17,000.00
Payment of Partially Secured Creditors, or Portion secured from Sale of Pledged Securities, per contra.....	3,000.00
Expenses of Administration and Commission to Trustee....	2,500.00
Total Credits.....	<u>\$46,150.00</u>
Final Dividend of 41.07% by Order of Court.....	18,850.00
Total Payments.....	<u>\$65,000.00</u>

*These are the amounts as per Statement of Affairs.

Summary

Total Receipts of Cash.....	\$65,000.00
Total Payments to Secured and Preferred Creditors and for Expenses.....	23,200.00
Total Dividends to Creditors, being 91.07%.....	<u>\$41,800.00</u>

§ 427. (3) The Realization and Liquidation Account

As previously stated, this is a summary of the trustee's records in selling the properties and collecting debts due to the bankrupt estate, and also of liabilities paid by him. In the following illustration the assets and liabilities are shown separately for greater convenience in illustrating the divisions and cancellations:

**REALIZATION AND LIQUIDATION ACCOUNT
OF LONGWORTH STORE COMPANY**

AS OF DECEMBER 1, 1916

ACCOUNT OF ASSETS

To be Realized:		Realized:	
Cash (see Cash Account)		Property	\$10,000.00
Property	\$9,000.00	Merchandise	16,000.00
Merchandise	15,000.00	Securities	28,000.00
Securities	28,000.00	Notes Receivable....	4,250.00
Notes Receivable....	4,250.00	Customers' Accounts	1,250.00
Customers' Accounts	1,200.00		
Total	<u>\$57,450.00</u>		
Supplementary Charges:			
Increase in Value of Property over Appraisalment	1,000.00		
Increase in Value of Merchandise over Appraisalment	1,000.00		
Customers' Increase.	50.00		
	<u>\$59,500.00</u>		<u>\$59,500.00</u>

ACCOUNT OF LIABILITIES

Liquidated		To be Liquidated:	
Preferred Claims....	\$700.00	Preferred Claims....	\$700.00
Secured Creditors...	20,000.00	Secured Creditors...	20,000.00
First Dividend to Creditors	22,950.00	Unsecured Creditors	25,000.00
Second Dividend to Creditors	18,850.00	Partially Secured Creditors	20,900.00
Total	\$62,500.00	Total	\$66,600.00
Commissions and Ex- penses	2,500.00	Supplementary Credits:	
Balance, Loss to Cred- itors, carried to Cap- ital Account.....	4,100.00	Commission and Ex- pense of Trustee..	2,500.00
	<u>\$69,100.00</u>		<u>\$69,100.00</u>

TRUSTEE'S CASH ACCOUNT

<i>Receipts</i>		<i>Payments</i>	
Amount on Hand.....	\$5,500.00	Preferred Claims.....	\$700.00
Sale of Property.....	10,000.00	First Dividend, 50%...	22,950.00
Sale of Merchandise..	16,000.00	Secured Claims.....	17,000.00
Notes Receivable.....	4,250.00	Secured Claims.....	3,000.00
Customers' Accounts..	1,250.00	Expenses and Commis- sions	2,500.00
Sale of Securities.....	28,000.00	Dividend, 41.07% Final Settlement	18,850.00
	<u>\$65,000.00</u>		<u>\$65,000.00</u>

NOTE: Vouchers for all cash disbursements should be available.

APPENDIX

INCORPORATION FORMS

Form 1. New York Charter

CERTIFICATE OF INCORPORATION OF THE HAMPTON TRADING CORPORATION

We, the undersigned, all being of full age and two-thirds being citizens of the United States and one of us a resident of the State of New York, for the purpose of forming a corporation under the Business Corporations Law of the State of New York, do hereby certify and set forth:

First. The name of said corporation shall be:
"Hampton Trading Corporation."

Second. The purposes for which said corporation is to be formed are as follows:

(a) To buy, sell, produce, manufacture, and dispose of all kinds of goods, wares, foods, potables, drugs, merchandise, manufactures, commodities, furniture, machinery, agricultural tools, supplies and products, and generally to engage in and conduct any form of manufacturing or mercantile enterprise not contrary to law.

(b) To lease, buy, sell, use, mortgage, improve, and otherwise handle, deal in, and dispose of all such property, real and personal, as may be necessary or convenient in connection with the aforesaid business of the Company.

(c) To conduct and transact business in any of the states, territories, or colonial dependencies of the United States and in any foreign country or countries, to have offices therein, and to hold real and personal property therein without limit, subject to the local law.

Third. The amount of capital stock of said corporation shall be Two Hundred and Fifty Thousand Dollars (\$250,000).

The amount of capital with which said corporation will begin business is Ten Thousand Dollars (\$10,000).

Fourth. The number of shares of which said capital stock is to consist shall be Two Thousand, Five Hundred (2,500) Shares of the par value of One Hundred Dollars (\$100) each.

Fifth. The principal business office of said corporation shall be located in the Borough of Manhattan and in the City, County, and State of New York.

Sixth. The duration of said corporation shall be perpetual.

Seventh. The number of directors of said corporation shall be five.

Eighth. The names and post-office addresses of the directors of said corporation for the first year are as follows:

Names	Addresses
Charles W. Hampton,	167-169 Center St., New York City
Samuel Johnson,	" "
James J. Miller,	" "
Lincoln Webster,	735 Main St., Albany, New York
Robert W. Kester,	" "

Ninth. The names and post-office addresses of the subscribers to this certificate, and the number of shares which each agrees to take in said corporation are as follows:

Names	Addresses	Shares
Charles W. Hampton,	167-169 Center St., New York City,	1,250
Samuel Johnson,	" "	500
James J. Miller,	" "	500

Tenth. At all elections of directors of this corporation, each stockholder shall be entitled to as many votes as shall equal the number of his shares of stock, multiplied by the number of directors to be elected, and he may cast all of such votes for a single director or may distribute them among the number to be voted for, or any two or more of them, as he may see fit.

IN WITNESS WHEREOF, we have made and signed this certificate in duplicate this 5th day of June, 1916.

CHARLES W. HAMPTON
SAMUEL JOHNSON
JAMES J. MILLER

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss.:

Personally appeared before me this 5th day of June, 1916, Charles W. Hampton, Samuel Johnson, and James J. Miller, to me personally known to be the persons described in and who executed the foregoing certificate and severally acknowledged that they executed the same for the purposes set forth.

ALBERT BURRELL,
Notary Public for
New York County

{ NOTARIAL }
{ SEAL }

Form 2. By-Laws*

BY-LAWS
OF THE
HAMPTON TRADING CORPORATION
NEW YORK

ARTICLE I—STOCK

1. Certificates of Stock shall be issued in numerical order from the stock certificate book, be signed by the President and Treasurer, and be sealed by the Secretary with the corporation seal. A record of each certificate issued shall be kept on the stub thereof.

2. Transfers of Stock shall be made only upon the books of the Company by the holder thereof in person, or by his duly authorized attorney. The stock books of the Company shall be closed to transfers twenty days before general elections and ten days before dividend days.

3. The Treasury Stock of the Company shall consist of such issued and outstanding stock of the Company as may be donated to the Company or otherwise acquired, and shall be held subject to disposal by the Board of Directors. Such stock shall neither vote nor participate in dividends while held by the Company.

ARTICLE II—STOCKHOLDERS

1. The Annual Meeting of the stockholders shall be held in the principal office of the Company in New York City, on the fourth Saturday of December of each year, at eleven o'clock A.M., if not a legal holiday; but if a legal holiday, then on the following Monday.

2. Special Meetings of the stockholders may be called at the principal office of the Company at any time, by resolution of the Board of Directors, or upon written request of the stockholders holding one-third of the outstanding stock.

3. Notice of Meetings, written or printed, for every regular or special meeting of the stockholders, shall be prepared and mailed to the last-known post-office address of each stockholder, not less than ten days before any such meeting, and if a special meeting, such notice shall state the object or objects thereof.

4. A Quorum at any meeting of the stockholders shall consist of a majority of the voting stock of the Company, represented in person or by proxy. A majority of such quorum shall decide any question that may come before the meeting.

*See Conyngton's "Corporate Organization."

5. The Election of Directors shall be held at the annual meeting of the stockholders. The election shall be by ballot and each stockholder of record shall be entitled to cast five votes for each share of stock held by him, and such votes may be cast all for one director or be distributed among the number to be elected, in any manner the voting stockholder may desire.

6. The Order of Business at annual meetings and, as far as it applies, at all other meetings of the stockholders, shall be:

1. Calling of roll
2. Proof of due notice of meeting
3. Reading and disposal of any unapproved minutes
4. Annual reports of officers and committees
5. Election of directors
6. Unfinished business
7. New business
8. Adjournment

ARTICLE III—DIRECTORS

1. The Business and Property of the Company shall be managed by a Board of five Directors, who shall be stockholders and who shall be elected annually by the stockholders for the term of one year, and shall serve until the election and acceptance of duly qualified successors. Any vacancies may be filled by the Board for the unexpired term.

2. A regular Meeting of the Board of Directors shall be held in the principal office of the Company in New York City, on the last Saturday of each month, at 12 noon, if not a legal holiday; but if a legal holiday, then on the following Monday.

3. Special Meetings of the Board of Directors, to be held in the principal office of the Company in New York City, may be called at any time by the President, or by unanimous written consent of all the members, or by the presence of all members at such meetings.

4. Notices of both regular and special meetings shall be mailed by the Secretary to each member of the Board not less than five days before any such meeting, and notices of special meetings shall state the purposes thereof.

5. A Quorum at any meeting shall consist of the majority of the entire membership of the Board.

6. Officers of the Company shall be elected by ballot of Directors at the first meeting after the election of Directors each year. Vacancies on the Board shall be filled for the unexpired term. The Board of Directors shall fix the compensation of the officers and agents of the Company.

7. The Order of Business at any regular or special meeting of the Board of Directors shall be:

1. Reading and disposal of any unapproved minutes
2. Reports of officers and committees
3. Unfinished business
4. New business
5. Adjournment

ARTICLE IV—OFFICERS

1. The Officers of the Company shall be a President, a Vice-President, a Secretary, and a Treasurer, who shall be elected for one year, and shall hold office until their successors are elected and qualified. The positions of Secretary and Treasurer may be united in one person.

2. The President shall preside at all meetings, shall have general supervision of the affairs of the Company, shall sign or countersign all certificates, contracts, and other instruments of the Company, as authorized by the Board of Directors; shall make reports to the Directors and stockholders, and perform all such duties as are incident to his office or are properly required of him by the Board of Directors. In the absence or disability of the President, the Vice-President shall exercise all his functions.

3. The Secretary shall issue notices for all meetings, shall keep their minutes, shall have charge of the seal and the corporate books; shall sign, with the President, such instruments as shall require such signature, and shall make such reports and perform such other duties as are incident to his office, or are properly required of him by the Board of Directors.

4. The Treasurer shall have the custody of all moneys and securities of the Company, and shall keep regular books of account and balance the same each month. He shall sign or countersign such instruments as require his signature, shall perform all duties of his office or that are properly required of him by the Board, and shall give bond for the faithful performance of his duties in such sum and with such sureties as may be required by the Board of Directors.

ARTICLE V—DIVIDENDS AND FINANCES

1. Dividends shall be declared only from the surplus profits, at such times as the Board of Directors shall direct; and no dividends shall be declared that will impair the capital of the Company.

2. The Moneys of the Company shall be deposited in the name of the Company, in such bank or trust company as the Board of Directors shall designate, and shall be drawn out only by check signed by the Treasurer and countersigned by the President.

ARTICLE VI—SEAL

1. The Corporate Seal of the Company shall consist of two concentric circles, between which is the name of the Company, and in the center shall be inscribed "Incorporated 1916, New York," and such seal, as impressed on the margin hereof, is hereby adopted as the corporate seal of the Company.

ARTICLE VII—AMENDMENTS

1. These By-Laws may be amended, repealed, or altered, in whole or in part, by a three-fifths vote of the entire outstanding stock of the Company, at any regular meeting of the stockholders, or at any special meeting where such action has been announced in the call and notice of such meeting.

2. The Board of Directors may adopt additional by-laws in harmony therewith, but shall not alter nor repeal any by-laws adopted by the stockholders of the Company.

Form 3. Certification of By-Laws

We, the undersigned, Charles W. Hampton and Samuel Johnson, respectively the duly elected President and Secretary of the Hampton Trading Corporation, a corporation organized under the laws of the State of New York, do hereby certify that the foregoing By-laws are the By-laws of the said corporation, duly adopted by the stockholders of said corporation at their first meeting held on the 9th day of June, 1916, in the office of the said corporation, 167-169 Center Street, New York City, as shown by the minutes of said meeting.

IN TESTIMONY WHEREOF, we have hereunto affixed our official signatures and the corporate seal of said corporation, this 9th day of June, 1916.

SAMUEL JOHNSON,
Secretary

{ CORPORATE }
SEAL }

CHARLES W. HAMPTON,
President

Form 4. Minutes of First Meeting of Stockholders

HAMPTON TRADING CORPORATION

MINUTES OF FIRST MEETING OF STOCKHOLDERS

HELD JUNE 9, 1916

Pursuant to written call and waiver of notice signed by all the incorporators, the first meeting of the Hampton Trading Corporation

was held in its principal office, 167-169 Center Street, New York City, at 4 P.M. on the 9th day of June, 1916.

Mr. Charles W. Hampton called the meeting to order, and by motion unanimously carried was appointed Chairman. Mr. Samuel Johnson was appointed Secretary.

There were present in person: Charles W. Hampton and Samuel Johnson.

James J. Miller's proxy was presented by Charles W. Hampton and was ordered filed with the Secretary.

The Secretary presented and read the call and waiver pursuant to which the meeting was held. On motion it was ordered to be entered in the minute book following the minutes of the meeting.

The Chairman then presented a copy of the Certificate of Incorporation and stated that the original had been filed with the Secretary of State on the 6th day of June, 1916, and that a duplicate copy had been filed for record with the County Clerk on the 8th day of June, 1916.

Upon motion duly made and carried, said Certificate of Incorporation was ordered received, the Directors named therein were recognized as the Directors of the Company, and the Secretary was instructed to spread the said Certificate in full upon the first pages of the book of minutes.

The Chairman presented a form of By-laws prepared by Counsel for the Company, which was read, article by article, and as a whole unanimously adopted and ordered to be entered in the book of minutes immediately following the Certificate of Incorporation.

The Secretary then presented a written proposal from Charles W. Hampton, of 167-169 Center Street, New York City, offering to transfer and assign to the Company his entire plant and business, comprising all of his assets and liabilities in exchange for One Thousand, Two Hundred and Fifty (1,250) Shares of the capital stock of the Company.

After due consideration, the Hampton proposal was ordered received and the following resolution in regard thereto was moved, seconded, and passed by unanimous vote:

WHEREAS, a proposition has been received from Charles W. Hampton, offering to sell, assign, and convey to this Company the plant, property, all assets and liabilities, and all of his established mercantile business, as a going concern, in exchange for One Thousand, Two Hundred and Fifty (1,250) Shares of stock in this Company; and

WHEREAS, it appears to the stockholders of this Company that the said property and business are desirable for the purposes of the Company and are reasonably worth the purchase price thereof:

NOW, THEREFORE, BE IT RESOLVED, that the said proposal for the exchange of said business, property, assets and liabilities for One Thousand, Two Hundred and Fifty (1,250) Shares of the capital stock of this Company, as set forth in said proposal, be and hereby is approved, and the Directors of this Company are hereby authorized, empowered, and instructed to accept the said proposal, and to issue One Thousand, Two Hundred and Fifty (1,250) Shares of stock of the Company for the said property and business in accordance with the terms.

There being no further business, the meeting was declared adjourned.

SAMUEL JOHNSON,
Secretary

CHARLES W. HAMPTON,
Chairman

Form 5. Proxy—First Stockholders' Meeting

PROXY

FOR

FIRST MEETING OF STOCKHOLDERS

KNOW ALL MEN BY THESE PRESENTS, that I, the undersigned, one of the incorporators of the Hampton Trading Corporation and a subscriber to the stock thereof, do hereby constitute and appoint Charles W. Hampton my true and lawful attorney, with full powers of substitution and revocation, to represent me at the first meeting of the stockholders of said corporation, to be held on the 9th day of June, 1916, and at any meeting postponed or adjourned therefrom, hereby granting my said attorney full power and authority to act for me at said meeting, and in my name, place, and stead to vote thereat upon the stock of said corporation subscribed for by me, or upon which I may then be entitled to vote, in the transaction of any and all business pertaining to the affairs of the Company that may be brought before said meeting, all as fully as I might or could do if personally present, and I hereby ratify and confirm all that my said attorney, or his substitute, shall lawfully do at such meeting in my name, place, and stead.

IN WITNESS WHEREOF, I have hereunto affixed my signature this 9th day of June, 1916.

JAMES J. MILLER [L. S.]

In presence of
WALTER H. KING

Form 6. Call and Waiver of Notice—First Meeting of Stockholders

CALL AND WAIVER OF NOTICE
FOR
FIRST MEETING OF STOCKHOLDERS

We, the undersigned, being all of the incorporators of the Hampton Trading Corporation, and all the subscribers to its capital stock entitled to notice of said meeting, do hereby call the first meeting of the stockholders of said corporation, to be held in the principal office of the Company, 167-169 Center Street, New York City, at 4 P.M. on the 9th day of June, 1916, for the purpose of receiving the charter, adopting by-laws, considering and acting upon a proposal for the issue of One Thousand, Two Hundred and Fifty (1,250) Shares of the capital stock of the corporation in exchange for property, and the transaction of all such other business as may be necessary or convenient in connection with the organization of said corporation, and we do hereby waive all requirements as to notice or publication of the time, place, and purposes of this first meeting and do consent to the transaction thereof of any and all business pertaining to the affairs of the Company.

Dated, New York City,
June 9, 1916.

CHARLES W. HAMPTON
SAMUEL JOHNSON
JAMES J. MILLER

Form 7. Minutes of First Meeting of Directors

HAMPTON TRADING CORPORATION
MINUTES OF FIRST MEETING OF DIRECTORS
HELD JUNE 9, 1916

Pursuant to written call and waiver of notice, the Board of Directors of the Hampton Trading Corporation held its first meeting in its principal office at 167-169 Center Street, New York City, at 5 P.M. on the 9th day of June, 1916.

Mr. Charles W. Hampton called the meeting to order, and on motion was elected temporary Chairman. Mr. Samuel Johnson was appointed Secretary pro tem.

There were present:

Charles W. Hampton
Samuel Johnson
James J. Miller
Lincoln Webster
Robert W. Kester

The Secretary presented the call and waiver of notice, pursuant to which the meeting was held, duly signed by all the Directors. It was ordered spread upon the minute book immediately following the minutes of the meeting.

The Chairman then presented a form of By-laws adopted by the stockholders at their first meeting, and stated that the next order of business as set forth therein was the election of a President, Vice-President, Secretary, and Treasurer, to serve for the ensuing corporate year and until the election and acceptance of their successors. The following officers were then elected by unanimous vote:

President.....	Charles W. Hampton
Vice-President.....	Lincoln Webster
Secretary.....	Samuel Johnson
Treasurer.....	James J. Miller

The permanent officers of the Company then took charge of the meeting.

By motion, duly seconded and passed, the amount of the Treasurer's bond was fixed at Three Thousand Dollars (\$3,000), such bond to be in form and with sureties approved by the Board.

The Treasurer-elect then presented a bond for said amount, signed by himself as principal, and by the Fidelity Guarantee Company of New York City as sureties. The form of the instrument and the sureties thereon meeting with the approval of the Board, the bond as presented was formally accepted and placed in custody of the President.

The Secretary then presented a form of stock certificate for approval, which was by motion adopted as the stock certificate of the Company; and the Secretary was instructed to spread the said form upon the pages of the minute book immediately following the record of the meeting.

The President then presented a written proposal from Charles W. Hampton, of 167-169 Center Street, New York City, offering to assign to the Company in exchange for One Thousand, Two Hundred and Fifty (1,250) Shares of stock, the assets and liabilities shown on the accompanying balance sheet, estimated to be worth One Hundred and Twenty-Five Thousand Dollars (\$125,000). The said proposal was ordered spread in full upon the minutes, and is as follows:

(Here should be recorded the proposal for the exchange of property for stock and the balance sheet which accompanies it.)

The President then presented the resolution of the stockholders, approving of said proposition, and authorizing and instructing the Directors to accept the same and to take such action in regard thereto as might be necessary to make such acceptance fully effective.

The President then called the Vice-president to the chair and withdrew during the discussion and vote upon the proposal.

The following resolution was thereupon moved, seconded, and after due discussion was unanimously adopted:

WHEREAS, the property offered in exchange for One Thousand, Two Hundred and Fifty (1,250) Shares of the capital stock of this Company by Charles W. Hampton, in his proposition to the Company, is adjudged by this Board to be of the reasonable value of One Hundred and Twenty-Five Thousand Dollars (\$125,000) and to be necessary for the use and lawful purposes of the Company;

RESOLVED, that the said property be received, and that this Board of Directors hereby, in accordance with the authorizations and instructions of the stockholders of this Company, accept the same in full payment for the said One Thousand, Two Hundred and Fifty (1,250) Shares of the capital stock of the Company, in accordance with the terms of said proposal; and the proper officers of this Company be hereby authorized and directed to receive the duly executed transfers and assignments of the property and business specified in said proposal, and to issue in exchange therefor One Thousand, Two Hundred and Fifty (1,250) Shares of stock of the Company, all full-paid and non-assessable, to such person or persons as may be designated by the written order of the aforementioned Charles W. Hampton.

The President was recalled to the room and resumed the chair. Upon motion duly made, seconded, and passed, the following resolution was adopted.

RESOLVED, that the Treasurer be and hereby is authorized and instructed to open an account for the Company with the Seaboard National Bank, of New York City, and to deposit therein all the funds of the Company coming into his custody; such account to be in the name of the Company and funds deposited therein to be withdrawn only by check signed by the Treasurer and countersigned by the President.

The following motions were then made, seconded, and duly passed by the unanimous vote of all present:

MOVED, that the office of Charles W. Hampton at 167-169 Center Street, New York City, as acquired by the Company, be and hereby is designated as the principal office of the Company within the State of New York.

MOVED, that the Secretary be hereby instructed to purchase all such record, stock and transfer books, and all such books of account and stationery and office supplies, as may be necessary for the proper operation and record of the Company's business.

MOVED, that the Treasurer be and hereby is authorized and directed to pay out of the funds of the Company the sum of Five Hundred Dollars (\$500) or so much of it as may be necessary to defray the cost of incorporation of the Company and the expenses incident thereto.

MOVED, that Lincoln Webster, Samuel Johnson, and James J. Miller be hereby appointed inspectors of election to serve at the first annual election of Directors of the Company, and at any election of Directors by the stockholders previous thereto.

There being no further business for consideration, the meeting was adjourned.

SAMUEL JOHNSON,
Secretary

CHARLES W. HAMPTON,
President

Pursuant to the instructions of the preceding minutes, the following instruments are hereunto appended in the order given:

1. Call and waiver of notice
2. Form of stock certificate

Form 8. Call and Waiver of Notice—First Meeting of Directors

CALL AND WAIVER OF NOTICE FOR FIRST MEETING OF DIRECTORS

We, the undersigned, being all the Directors of the Hampton Trading Corporation, do hereby call the first meeting of said Directors to be held in the office of the Company at 167-169 Center Street, New York City, at 5 P.M. on the 9th day of June, 1916, for the purpose of electing officers of the Company, acting upon a proposition for the issue of One Thousand, Two Hundred and Fifty (1,250) Shares of the capital stock of the Company in exchange for property, and the transaction of all such other business as may be necessary or desirable

in connection with the organization of the Company and the promotion of its business, and we hereby waive all statutory and by-law requirements as to notice of time, place, and object of this first meeting, and consent to the transaction thereat of any and all business pertaining to the affairs of the Company.

New York City,
June 9th, 1916.

CHARLES W. HAMPTON
SAMUEL JOHNSON
JAMES J. MILLER
LINCOLN WEBSTER
ROBERT W. KESTER

NOTE: For general form of stock certificate, see Chapter V.

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